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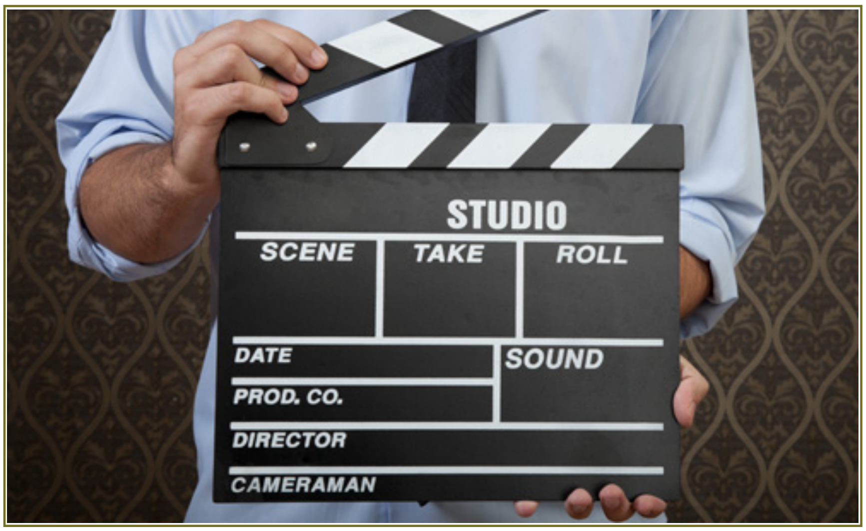
Lights, Camera, Taxation! A Look into Tax Issues of the Entertainment Industry



"There's no business like show business." This is true especially when it comes to tax planning for entertainers.

Although taxpayers in the entertainment industry face tax planning issues similar to those of other high net worth individuals, the nature of the industry creates unique areas of exposure. From the various types of income, to the maximization of deductions and benefits, this article will highlight the need for tax planning that is as creative as the individuals being taxed.

Types of Income

The type of income entertainers receive depends on the activities or services performed and their rights as per contractual agreement. Entertainers involved in film and television production, including actors and other employees of studios and production companies, generally receive wages or salaries for their performance or compensation based on net profits or gross receipts of the production. Additionally, actors may receive residuals —payments for past performances and re-runs of television shows, movies, and commercials—which are considered personal services income and are treated as wages.

Copyright owners, such as authors, recording artists, and songwriters, receive payments in the form of royalties or license fees. Royalties are periodic payments generated by the sale of copyrighted material (e.g., books, records and merchandising) through the performance (by someone other than the artist), exhibition or distribution of such. As [intellectual] property protected under copyright laws, the sale and license of copyrights could be subject to favorable capital gains treatment as opposed to being treated as ordinary income.

Athletes and other celebrities receive endorsement income for recommending products or making appearances, and participating in photograph sessions for their sponsors. Whether such income will be treated as royalty income (i.e., license of intangible property) or personal services income will depend on the actual purpose of compensation (usually defined in the contract). The income will be considered royalty income if the entertainer is paid for the right to use his name and likeness (e.g., his face on a shirt). However, if the entertainer is compensated for a performance, or an appearance in commercials or interviews, the income will be characterized as personal services income.

Entertainers are also compensated in forms other than cash. Fringe benefits and goods, such as wardrobes, housing, meals, travel and transportation, given to entertainers in lieu of, or in addition to, cash payments are considered compensation and should be included in their taxable income.

Loan-Out Corporations

A loan-out corporation (LOC) is a corporation wholly-owned by the entertainer, who is actually its employee. It can be an LLC, an S corporation or a C corporation. The choice will be dependent upon the facts and circumstances associated with the individual entertainer.

The LOC enters into agreements with third parties whereby the entertainer's services are provided in exchange for compensation which is then paid out to the entertainer. The benefits of operating through a LOC may include:

1. 100% deduction of business expenses;
2. deduction for a limited cost of life insurance and 100% deduction for disability insurance;
3. the ability to set up a medical reimbursement plan through which medical and insurance costs can be deducted; and
4. the ability to set up a richer pension plan other than an IRA. There is also an opportunity to defer income to a later year.

However, Internal Revenue Service (IRS) can disregard LOCs and reallocate income to the individual if: 1) the purpose of the LOC was to evade tax; and 2) the LOC performs services for only one other entity. The rules associated with LOCs are complex and therefore, it is necessary to consult with a qualified professional before establishing an LOC.

Passive Activity Losses

Many entertainers have also tried to take advantage of passive activity loss rules by trying to convert their personal service income into passive activity income. As such, it can be offset by passive activity losses. Passive activities include: 1) equipment rentals; 2) royalties; and 3) any activity in which the entertainer does not "materially participate." Some entertainers have tried to simultaneously perform personal services while renting out equipment. Others have tried to convert their personal services income into passive activity income by receiving equity interest in a film rather than receiving deferred compensation.

However, the Treasury Department has broad discretion in determining whether such income can be characterized as passive activity income and IRS-issued audit guidelines draw attention to such attempts. For instance, the guidelines state that equipment rentals from entertainers who perform personal services will be considered personal services unless: 1) equipment rent is more than 20% of the entire income attributable to the activity; and 2) equipment is rented for more than seven days.

Trap for the Unwary: Bad Deferred Comp?

Many entertainers are paid under deferred compensation arrangements through which they avoid current taxation by deferring their income to future years. However, only deferred compensation plans that meet strict requirements will be respected. “Permitted plans”:

1. follow a fixed payment schedule or are payable on or after the earliest date of a number of specified events;
2. do not allow for acceleration of payment;
3. are irrevocably chosen (if a choice between deferred compensation and current compensation is given);
4. must be paid on the date of scheduled payment;
5. do not allow for placement of assets in a foreign trust; and
6. are “established” and specify time and form of payment.

Should the permitted plans not comply with these requirements, they will be subject to hefty tax penalties and interest charges.

State and Local Tax Issues

Entertainers often “go where the money is,” that is, where their work takes them. As such, they can be subject to tax in many states, particularly because their whereabouts can easily be tracked due to their celebrity status. Entertainers are normally subject to tax in their resident state based on worldwide income. Entertainers may also be subject to tax in nonresident states to the extent that income was derived or “sourced” to that state. In order to determine the states in which their income is sourced, entertainers must determine “where performance occurs” and how many days they worked within that state over total days worked. Some resident states offer tax credits for taxes paid to other jurisdictions but are likely limited to the tax rate of the resident state. A proper assessment of income sourcing and allocation is the key to avoiding heavy penalties for lack of filing in a necessary jurisdiction.

There are many ways to minimize tax in the entertainment industry but proper tax planning is imperative.

See our next issue of For the Record as we continue to explore additional tax issues in the entertainment industry.

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Recent Tax Law Changes in New York, New Jersey and Connecticut

This article provides an overview of recent tax law changes in New York, New Jersey and Connecticut affecting individuals and corporations.

New York

This year, for the first time since 2006, New York enacted its budget before the March 31st deadline. Miraculously, there were no major tax increases. In fact, most of the tax provisions within the budget legislation either created or expanded credit and incentive opportunities.

One such opportunity is the Excelsior Jobs Program Act (EJPA). Under this program, qualifying companies meeting various investment and new job creation levels can qualify for a variety of tax credits. One component of the EJPA is the Excelsior Jobs Tax Credit (EJTC). Previously, the credit was limited to $5,000 (up to the first $187,781 of wages) per employee per year. Now, however, the credit is computed by simply multiplying each qualifying employee's wages by 6.85% with no annual limit. For certain employers in the high-tech area where wages tend to be higher, the elimination of the annual limit can be material. For example, a qualifying employee earning a salary of $500,000 will generate a credit of $34,250 as opposed to the $5,000 allowed under the old law.

Another component of the EJPA is the Excelsior Research and Development (R&D) Credit. Previously, the credit was limited to 10% of the federal R&D credit. However, as a result of the new legislation, qualifying taxpayers can claim up to 50% of the federal R&D credit. Again, this is a significant increase in benefits for taxpayers who create or expand their investments in New York.

Perhaps the best news to come out of New York's budget legislation is that there was no extension of the increased 8.97% tax rate for individuals with adjusted gross income above $500,000. When enacted in 2009, the increased rate was set to expire on December 31, 2011. Although there was much concern that the legislature would extend the provision, it did not. Hence, for tax years beginning after January 1, 2012, New York's highest tax rate for individuals will return to the pre-2009 level of 6.85%.

New Jersey

Like New York, New Jersey has not enacted any new or increased any existing taxes in the latest legislative session. That's good news for individuals and corporations within the state. However, in June New Jersey did enact a law which phases in a single sales factor regime for apportioning income for corporate taxpayers. As a result, out-of-state companies stand to see their corporate taxes increase.

Under the new legislation, corporate taxpayers will begin to migrate towards a single sales factor beginning in 2012. For tax year 2012, the apportionment factors will be weighted as follows: sales (70%); property (15%); and payroll (15%). For tax year 2013, the apportionment factors will be weighted as follows: sales (90%); property (5%); and payroll (5%). For tax years beginning on January 1, 2014 and thereafter, corporate taxpayers will apportion their income purely based on the amount of sales in New Jersey over sales everywhere.

Single sales factor apportionment regimes tend to shift the corporate tax burden from in-state companies (that tend to have significant property and payroll in the taxing state) to out-of-state companies (that generally tend to have just sales in the taxing state).

It is highly advised for both in-state and out-of-state companies to refocus how they attribute sales of tangible personal property and services in New Jersey as the state migrates to the single sales factor. New Jersey does not conform to the Uniform Division of Income for Tax Purposes Act, and its sales sourcing rules do differ in some cases from the methods applied in other states.

Connecticut

In the most recent legislative session, Connecticut has enacted widespread tax increases which will immediately affect individuals and businesses operating in the state.

Effective January 1, 2011, Connecticut increased the number of tax brackets from three to six with the top marginal rate increased to 6.7%. The state has issued new withholding tables to account for the new brackets and rate changes. Individuals making quarterly estimated tax payments will have to adjust their payments (beginning with the September 15th payment) to take the new rates into account.

Also effective January 1, 2011, the gift and estate tax exemption amounts have been reduced from $3.5 million to $2.0 million. The gift tax includes all Connecticut taxable gifts made since the tax was enacted on January 1, 2005, and can include Connecticut real property, tangible property situated in Connecticut and gifts of intangible property made by Connecticut residents. The estate and gift tax rates begin at 7.2% for transfers over $2 million and graduate up to a maximum of 12% for transfers over $10.1 million.

Effective July 1, 2011, the state sales tax rate increased from 6% to 6.35% for most sales of taxable property and services. However, sales of certain "luxury" items including motor vehicles sold for $50,000 or more; watercraft sold for $100,000 or more; and jewelry (whether real or imitation) sold for $5,000 or more per article, is subject to a 7% tax rate in lieu of the 6.35% rate.

The new law also subjects a variety of new services to the sales tax including: valet parking at airports; yoga instruction; motor vehicle storage and road services; livery services; cosmetic medical procedures; manicure services; and spa services.

Connecticut has implemented a "NY Amazon" type nexus standard for remote retailers. Similar to New York, Connecticut will seek to require online retailers, with no physical presence in the state, to collect sales tax on sales to Connecticut consumers where such retailers use in-state, commission-based affiliates to generate sales. Connecticut expects this to increase the number of online retailers that will be required to collect and remit sales tax.

As for Connecticut's corporate income tax, the 10% surcharge that was set to expire on December 31, 2011, has now been increased to 20% (only applicable to corporations with net income in excess of $100 million) and extended through December 31, 2013. The state increased the surcharge in lieu of enacting a sales sourcing "throwback" rule that would have increased the Connecticut sales factor for businesses that make sales in other states where they are not subject to taxation.

Finally, Connecticut enacted new taxes and fees on hospitals, nursing homes and electric generation companies. These new taxes and fees generally went into effect on July 1, 2011. Therefore, as you can see from the breadth of the changes, a fresh review of your Connecticut business operations and tax compliance is well advised.

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Appraisal Considerations for Undivided Interests in Real Property

Fractional (or undivided) interests in real property are common subjects of estate and gift planning.

Since they are typically transferred at a value that incorporates a discount from a pro-rata share of the property's total value to reflect a lack of control and marketability, these transactions are often challenged by Internal Revenue Service (IRS), as evidenced by the recent *Ludwick*[1] case. This article discusses the steps that should be taken when planning to transfer undivided interests as part of any estate or gift planning program.

An undivided interest is a direct fractional interest in real property. Unless there is an operating agreement in place that dictates the respective owners' rights and restrictions, state law generally governs owners' rights (e.g., the right to occupy, use, operate and lease the property).

The reason that undivided interests typically sell at a discount relates to an owner's difficulty in selling its interest and an inability to sell the property without the other owners' consent. A buyer of an undivided interest lacks the ability to solely control the property and, as a result, typically faces the following impediments:

- an inability to obtain normal bank financing to purchase the interest;
- potential disagreement with co-owners related to the extent of repairs and maintenance;
- potential disagreement with co-owners regarding the sale or leasing of the property; and
- potential disagreement with co-owners that could lead to a lengthy and costly judicial partition.

When transferring undivided interests as part of a taxable transaction, it is critical that proper planning be performed and a *qualified appraisal* be prepared by a *qualified appraiser*[2] as of the date the transaction is consummated. If the asset is being gifted, the taxpayer is required to attach the appraisal to the gift tax return and disclose that there is a valuation discount. If the asset is being donated to charity, then the appraisal must be attached to the individual income tax return if the value is greater than $5,000.

When preparing to transfer an undivided interest, many taxpayers consult with an attorney and draft an operating agreement (often referred to as a "tenancy in common" agreement). A properly prepared operating agreement serves to clearly define owners' rights and restrictions. Clauses can include mechanisms to settle disputes and remove the legal right to partition. The removal of owners' rights can result in a reduction in the value of the undivided interest. A competent attorney can assist the taxpayer with understanding the benefits stipulated in the agreement and properly prepare a clear and concise document.

In addition to meeting the qualified appraisal requirement, it is important that the appraisal report carefully consider the specific facts and circumstances. The report should provide details regarding the nature of the real property and clearly detail the rights and restrictions associated with the undivided interest, including the terms and conditions associated with any operating agreement. The report should also detail how the various approaches to value were considered and how the underlying assumptions were developed and supported. The following three approaches are commonly considered and reconciled to reach the ultimate conclusion.

Transaction Analysis: This method involves examining historical sales of undivided interests that have been reported through various studies. As part of this analysis, the individual transactions are examined and compared to the subject interest and relevant adjustments are made to reflect differences. From an IRS review perspective, it is critical that the type of property, age of the transaction, relationship of the parties involved and transaction terms be carefully considered.

Real Estate Partnership Analysis: This method involves examining the combined adjustment for both lack of control and marketability observed in historical transactions involving minority interests in Real Estate Limited Partnerships (RELPs). When preparing a defensible appraisal, it is critical that each transaction be compared and contrasted with the subject interest and adjustments be made for the type of assets, holding period, reputation and experience of management, level of control, sales restrictions, stability of cash distributions, profitability of the property, and leverage of the property, among other factors.

Partition Cost Analysis: This method estimates the total economic costs to partition and sell a property (as well as the feasibility of partitioning a property). From an IRS review perspective, it is important to properly value the underlying property and support assumptions, which include careful consideration of appreciation rates, years to partition, cost to partition, cash flows during the partition period and the applicable discount rate.

In the *Ludwig* case the Court concluded a discount of 17% but discounts can often far exceed this amount. However, it should be noted that this case had a unique set of facts. While there was a section of the tenancy in common agreement that prohibited either co-tenant from seeking a partition, another section specifically gave each co-tenant the right to sell his/her undivided interest to the other co-tenant at a pro rata value or to sell the entire property. The Court appears to have equated this provision as an absolute right to force a quick judicial partition of the property thereby significantly mitigating the discount.

In conclusion, the taxpayer should be prepared to have IRS challenge his/her appraisal. It is important that a qualified appraisal report be obtained that clearly describes the underlying property and the subject interest, including rights and restrictions. Furthermore, if an operating agreement is used, it is critical that it be clearly drafted.

[1]*Ludwick v. Commissioner*, Case No. 3281-08, 3282-08, U.S. Tax Ct., May 10, 2010
[2]Both terms are defined in Internal Revenue Code 170(f)(11) and dictate what minimum information needs to be included in a Qualified Appraisal report and the minimum experience and educational requirements for a Qualified Appraiser.

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Evolution of Emerging Market Debt

Investors are closely reevaluating their portfolios following a global credit crisis and currently facing the headwinds of increasing sovereign credit risk, rising inflation, and escalating worldwide fiscal deficits.

As investors find themselves looking outside the more traditional fixed income assets, interest has increased in the category of emerging market debt (EMD). EMD is debt issued by entities domiciled in under-developed nations. As a whole, EMD obligations have demonstrated resilience during this recent turbulent period. Historically, when compared to developed market fixed income, EMD has been considered an unstable asset class. However, volatility in EMD investments has been trending downward over the last few years due to strength in the underlying fundamentals and the maturity of this asset class. Capital inflows into EMD have been staggering, with a record breaking $76 billion moving into EMD in 2010. We believe this trend will likely continue as more investors recognize the relative strength of these fast-growing economies.

Why has EMD been so resilient? The broadened acceptance of this asset class is predicated on the significant improvement in the economic fundamentals of emerging market countries. This is primarily due to less restrictive government regulations, abundant access to natural resources, and a large and innovative working-age population. Emerging market countries are economically healthier in comparison to what they were a decade ago. Stricter monetary and fiscal policies, as well as robust trade flows, have led to strong current account surpluses and foreign exchange reserves. These factors have given EMD the ability to avoid, or otherwise mitigate, adverse global shocks.

Historically, the most common way to access EMD has been to invest in dollar-denominated sovereign debt. This type of debt investment provides a relatively high level of transparency (governments face constant global scrutiny over monetary and fiscal policies) and gives an investor the ability to avoid the volatile currency movements of the issuing sovereignty. However, the universe of dollar-denominated EMD securities has diminished as emerging market countries have increased their use of excess reserves to pay down external debt. This decrease in supply, coupled with a sustained belief that emerging markets will continue to outpace the economic growth and stability of more developed nations, has investors considering a broader set of alternatives including local currency sovereign debt, dollar-denominated and local currency corporate debt, and inflation-linked assets.

Although the currency risk associated with local currency EMD is real, it is imperative that investors allow for some degree of local currency exposure in order to take advantage of the complete opportunity set of EMD. Many emerging market countries are decreasing their financial dependence on the dollar, thus increasing the investable universe of locally denominated debt. In contrast to developed markets (particularly the United States, Europe and Japan), where debt as a percentage of gross domestic product (GDP) has increased significantly, local currency EMD as a percentage of GDP has remained flat. Local and dollar-denominated debt issued by the same government typically carry differing credit ratings due to the fact that governments have the ability to service their locally issued debt through various fiscal and monetary efforts, making locally issued debt less subject to the risk of default.

As emerging countries' debt markets continue to evolve and creditors capitalize on the growing pools of available liquidity, the availability of corporate credit is expanding at a rapid clip. Issuance now spans over 35 countries and includes a variety of sectors including telecom, oil and gas, minerals and mining, and banking. Emerging markets corporate fixed income should provide diversification within portfolios and incremental yield through investments in quality issuers.

The inflation-linked bond market allows investors to capitalize on the attractive real yields that emerging market countries provide, without the inherent inflation risks in nominal bonds. The issuance of inflation-linked emerging markets debt extends to approximately a dozen emerging market countries. As the demand for these types of securities increases and inflation pressures mount worldwide, it is fair to expect issuance from additional emerging market countries in the near future.

While the risks associated with EMD that investors have traditionally sought to avoid still exist (political instability, protectionism, currency management, etc.), the long-term systemic effect of those risks on the asset class has diminished relative to more developed nations. The consensus opinion is that these risks are more likely to result in short periods of heightened volatility, rather than long-term disturbances in the secular maturation of the asset class.

The majority of emerging market countries have gone from current account deficits to surpluses. This has led to an increase in their currency reserves, and lower and more sustainable inflation rates as they have transitioned from fixed to floating exchange rates. Moreover, these improved fundamentals are also supported by significantly higher GDP growth rates (IMF forecasts GDP growth of roughly 6% for emerging markets through 2014 versus approximately 2% for developed countries).

For most investors, the access, breadth and liquidity of mutual funds will provide the appropriate exposure to EMD. The mandate of the specific mutual fund the investor chooses can vary widely, from globally diversified, to industry or geographically focused, to dollar-hedged or -unhedged, depending on the investors' preference.

In summary, the relatively new development and evolution of EMD securities has provided skilled portfolio managers with the potential to provide investors with many opportunities to exploit mispriced markets, increase their diversification among fixed income investments, and achieve more attractive risk/return characteristics within their overall portfolio.

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Your Picasso Can Cost You More Than You Think

Have you purchased artwork, jewelry, furs, or other large ticket items from businesses located outside Illinois and either brought them or had them shipped to you inside the state?

Have you purchased an automobile, boat, RV or aircraft for use in Illinois that you registered outside the state? If you did not pay sales tax to the retailer or individual from whom you made the purchase, you probably have a “use tax” obligation. A use tax compliments the sales tax in that it is imposed on the individual (or business) who purchases the tangible personal property as opposed to the out-of-state retailer or vendor who made the sale. Examples include the following:

- an item of tangible personal property was purchased in another state or country and brought into your home state for use;
- an item of tangible personal property was purchased by subscription, through the internet or from a mail order catalog company, without being charged sales tax; and
- personal property (like furniture) was acquired with the purchase of real estate.

If a seller fails to collect sales tax on the sale of taxable goods, the tax obligation shifts to the purchaser in the form of a use tax. The individual or business must self-assess and pay the use tax to the state where the taxable tangible personal property will be used, consumed, stored or given away.

States like Illinois are aggressively going after individuals to collect use tax *plus* interest and penalties, which may end up being significantly more than the amount of tax that would have been originally due. Sources for finding potential targets of unpaid tax liabilities include U.S. customs declarations of individuals and of businesses that are making acquisitions on behalf of their clients. Additionally, there may be a general sales and use tax audit of an out-of-state retailer where the auditor picks up names of individuals through the course of the audit. Once the audit is initiated, the states may be able to have an unlimited lookback for untaxed purchases if the taxpayer never filed a use tax return as statute has never expired on that audit period. Typically, once you have been contacted by the state, you are no longer able to participate in amnesty or voluntary disclosure programs which may offer an abatement of penalty and interest or a limited lookback in the case of voluntary disclosure programs.

Beginning January 1, 2011 through October 15, 2011, the State of Illinois has instituted an Illinois Use Tax Amnesty Program which is available to individual taxpayers to remit their outstanding use tax liabilities. This program is available only to individuals and applies to use tax owed on purchases of tangible personal property used in the state of Illinois.

Specifics about the Illinois Use Tax Amnesty

- The Amnesty application period runs from January 1, 2011 through October 15, 2011.
- Amnesty applies to use taxes due for purchases made between June 30, 2004 and prior to January 1, 2011.
- Amnesty is applicable for use tax owed on purchases of tangible personal property from a retailer for use in Illinois.
- Taxpayers cannot participate if they are under audit or have been contacted in writing by the Illinois Department of Revenue concerning Illinois use tax.
- Taxpayers cannot participate if they are a party to a criminal investigation or to any civil or criminal litigation for nonpayment, delinquency or fraud in relation to Illinois use tax.
- If an eligible tax liability is paid in full during the Amnesty period, penalties and interest will be waived.
- Failure to pay all eligible taxes due for the Amnesty period shall invalidate any Amnesty granted.

To participate in the Amnesty program, taxpayers must complete an application for each year that they have a use tax liability. For tax year 2010, taxpayers may report their use tax on their individual income tax return if the amount owed is $600 or less.

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Has the Value of Your Roth IRA Declined Since a Recent Conversion?

During the first week of August the Dow Jones Industrial Average and the S&P 500 fell by 11.2% and 13.3%, respectively. This unfortunate situation creates an opportunity for those who may have converted a regular IRA to a Roth IRA in 2010 or an earlier point in 2011.

Over the last two years we have advised that our clients with sizeable balances in their traditional retirement accounts convert these accounts to Roth IRAs for a variety of reasons. The conversion of a traditional retirement account to a Roth IRA causes the balance of the account to be subjected to income tax at the individual's highest marginal rate. Those who converted to a Roth IRA during 2010 or 2011 can take advantage of the recent substantial drop in account values by recharacterizing the conversion, which essentially reverts the Roth IRA back to its original status. You may then reconvert to a Roth IRA at a lower account value, thereby reducing the tax liability from the conversion. There are slightly different considerations for Roth conversion that took place during 2010 and those that took place in 2011, which will be explained below.

2010 Recharacterization:

For 2010, the S&P 500 opened at 1,117, hit a low of 1,023 during August and closed out the year at 1,258. At the time of writing this article the S&P 500 is at 1,145. If your conversion was well timed during 2010, it is possible that the current value of your account still exceeds its value as of the date of its Roth conversion. However, if the market continues to decline as the year goes on, it may be worth re-examining whether a recharacterization would benefit you. Technically, you have until October 17th, 2011, to make this determination. However, you should keep in mind that the logistics of making the recharacterization and reporting the impact on your tax return may take some time.

If you converted to a Roth IRA in 2010 during a period when market values exceeded the current 2011 market lows, then a recharacterization could be of benefit to you. Assume for a moment that you had a traditional IRA with a market value of $2,000,000, the value of your account exactly correlates with that of the S&P 500, and that you originally converted this account to a Roth IRA on 12/31/2010, when the S&P 500 reached its high for the year at 1,258. Further, assume that your marginal federal income tax rate is 35%. Upon the conversion of your retirement account to a Roth IRA you would have incurred a federal tax liability of $700,000. Under the current assumptions, the value of your account would have fallen by 11% to $1,780,000 and let's assume the value stays there for the next 30 days. If you were to recharacterize the conversion, basically undoing the original Roth conversion, and then 30 days later (the time restriction imposed by Congress) reconvert the account back to a Roth, several tax implications would happen. The $700,000 tax liability from the 2010 conversion would be eliminated by the recharacterization. Then upon reconverting to a Roth IRA in 2011 at the lower account value of $1,780,000, a 2011 tax liability of $623,000 would be generated. While fundamentally your strategy of converting to a Roth and the income tax and estate tax benefits it offers are still in place, you have reduced the tax incurred by the transaction by $77,000. If you factor state taxes into the analysis, the savings become even more substantial.

While the above analysis illustrates that the current market volatility may provide the opportunity to substantially reduce the tax costs associated with converting a retirement account to a Roth IRA, there are many other important considerations. You should discuss the following with your tax advisor (note that if you converted to a Roth IRA during 2010 time is of the essence as the deadline to recharacterize the Roth conversion is October 17, 2011):

- whether you will need to amend your 2010 return to account for the recharacterization;
- the timing of recharacterizing the conversion back to a traditional IRA;
- the timing of reconverting the traditional IRA back to a Roth IRA and the implications of continued market volatility;
- the impact on the timing, effective tax rate and net amount of income taxes resulting from the conversion;
- the logistics of making the recharacterization and the reconversion back to a Roth IRA; and
- the methods of hedging the reconversion to mitigate the risk of adverse market fluctuations.

2011 Recharacterization:

The analysis for recharacterizing a 2011 conversion is similar in most respects for 2010 conversions. There are two significant differences; first, you have until October 15, 2012 to implement the recharacterization, and second, if you recharacterize in 2011, you cannot reconvert the account to a traditional IRA until January 1, 2012.

The S&P 500 opened the 2011 year at 1,258 and is currently trading at 1,145. Through August 8, 2011 the average value of the S&P was 1,304. Nearly everyone that converted their retirement account to a Roth IRA during 2011 will have the potential to benefit from a recharacterization and reconversion. This is because the recent market downturn has probably lowered the value of the account to a point well below the value at the time of the original conversion. However, whether there is an actual benefit will depend on the level of the market at the point of reconversion to a traditional IRA, which cannot be sooner than January 1, 2012.

The following example will demonstrate the potential income tax savings of a recharacterization to those that originally converted their retirement account to a Roth IRA during 2011. In order to illustrate this point the following assumptions are used: the value of the account on the day it was converted is $2,000,000; the value of the account exactly correlates with the S&P 500; at the time of the conversion the value of the S&P 500 was its average for the year of 1,304; and that the marginal federal tax rate is 35%. Additionally, assume that the recharacterization took place on August 8, 2011, and the account is reconverted to a Roth IRA on January 1, 2012. Finally, hypothetically we will assume that the S&P 500 gains 25 points during the statutory waiting period for a reconversion to a Roth IRA for a value of 1,159.

Upon the original 2011 conversion of the $2,000,000 retirement account to a Roth IRA, a federal tax liability of $700,000 was incurred. Upon the recharacterization of the account, that tax liability is eliminated. Then on January 1, 2012, the account is reconverted while the S&P 500 is at the hypothetical 1,159. At this time the account, which tracks the S&P 500, is now valued at $1,777,607. This second conversion to a Roth in 2012 generates a tax liability of $622,162. Fundamentally, all the income tax and estate tax benefits of converting to a Roth are still in place. However, by recharacterizing the original conversion and then later doing a second conversion, a federal income tax savings of $77,837 has been realized. The savings become even greater when state income taxes are factored in. If the market fares worse during the reconversion waiting period, the tax savings will be larger. Conversely, if the market fares better, the tax savings will be smaller and could potentially be eliminated entirely. Ideally, the reconversion to a traditional IRA would take place at the market's lowest point, which is impossible to predict with certainty.

While it is impossible to predict the market's low and where it will be after the waiting period for a second conversion to a Roth IRA, the above example illustrates that you may obtain some benefit from hindsight. If the market remains at a reduced level or continues its decline, recharacterization could substantially lower the tax costs of the conversion to a Roth IRA. However, there are many other important considerations that are unique to each individual situation. Please contact your tax advisor to discuss whether a Roth IRA recharacterization or a conversion of a traditional IRA to a Roth may be appropriate for you.

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Southern California Chapter of the Appraisal Institute "Valuation for Financial Reporting" Seminar

On May 25, 2011, the Southern California Chapter of the Appraisal Institute welcomed WTAS' R.J. Starr as a guest panel speaker. Before a crowd of 100+ valuation professionals, Starr spoke on a panel that included members from WTAS, BDO, Deloitte, KPMG and PWC related to the reporting requirements for financial reporting valuation.

In their 90-minute panel discussion, participants discussed the need and requirements for financial reporting valuation analyses, the qualifications and experience required to perform financial reporting analyses, and the overall valuation process.

The discussion kicked off by identifying Generally Accepted Accounting Principles (GAAP) compliance projects that may require real estate valuation components, including mergers/acquisitions, impairment analyses and part of larger business-related activities. The discussion progressed towards the convergence of U.S.-based GAAP compliance as set by the Financial Accounting Standards Board (FASB) and international financial reporting compliance with International Financial Reporting Standards (IFRS) as dictated by the International Accounting Standards Board (IASB). All panel members agreed that convergence with IFRS is inevitable but the timing is still unknown. Questions from the audience led to a discussion about the applicable financial reporting standards, and the moderator also focused on the importance of relevant Statements of Accounting Standards (SAS) issued by the Accounting Standards Board.

The panel discussion concluded with the importance and role of audit reviews as well as best practices for the valuation industry. Many of the appraisers in attendance were concerned with their clients' auditors questioning the assumptions and value conclusions for reports intended for various purposes; however, the panel concluded that audit review was a necessity in the contemporary financial environment. Many of the panel members from audit firms who conduct valuation reviews outlined the level of scrutiny the auditors are under with respect to public companies. The increased pressure is not just from the Securities and Exchange Commission (SEC) but also the Public Company Accounting Oversight Board (PCAOB) over the past two to three years. The topic turned towards best practices in the real estate valuation industry, including methodologies and work product. The panel ultimately concluded that a summary narrative report was the optimal work product for financial reporting purposes.

Those in attendance applauded the proactive nature of the conference and panel (to the eminent IFRS convergence) as excellent knowledge exchange and education. Several in the audience noted that it is seldom that they engage in valuation at this level but appreciated the knowledge nonetheless. In the end, Starr's contribution to the Appraisal Institute's spirit of mutual professional aid was successful by sharing how valuation professionals can work together in an effort to serve clientele. Please see www.sccai.org for more details.