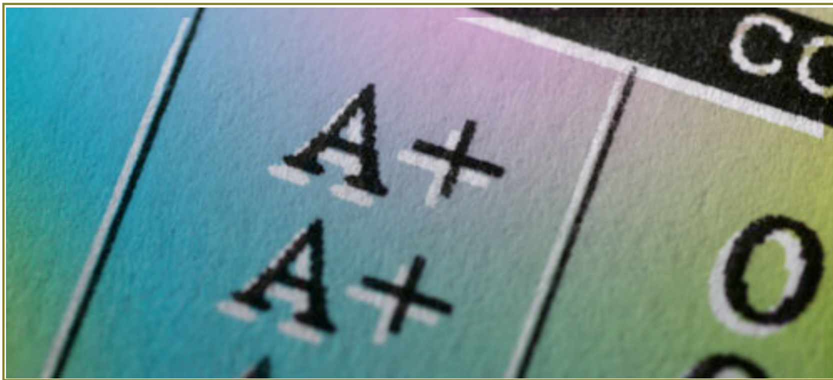
Era of Deleveraging and High Quality Investment Strategies



"Quality is never an accident; it is always the result of high intention, sincere effort, intelligent direction and skillful execution; it represents the wise choice of many alternatives."
— William A. Foster

For years, financial institutions were more than willing to extend credit haphazardly to feed the insatiable spending and speculative appetites of consumers, investors and businesses. Last year, however, the window on this era of excessive leverage slammed shut, exemplified by the demise of several long-established firms, massive write-downs by financial institutions, rating downgrades, increased margin and capital calls, and a crushing of consumer confidence initiating a global credit freeze.

Since 1981, the U.S. GDP has increased by about $11 trillion, while private sector debt has ballooned to an astounding $22 trillion. Over the last decade, economic growth (as measured by GDP) has averaged 2.7% per year. Yet, during that time, the debt burden has increased at a pace of almost twice that amount.(1) This growth in the debt burden was clearly unsustainable, and we are now experiencing the painful process of unwinding the excess leverage.

As we struggle through the effects of global deleveraging, certain businesses may be more adversely affected than others by tighter credit terms and increased limitations on sources of financing. Many businesses finance working capital costs such as inventory and payroll, as well as most of their longer-term capital budgeting projects. In a new

era where it is no longer feasible to load up the balance sheet with debt, high quality companies that have appropriately positioned themselves to endure and thrive should perform well relative to the overall market. In today's environment, the lower leverage carried by high quality companies makes them particularly attractive investments. Without a significant dependence on external sources of financing, high quality companies can grow their business through internally-generated sources, leading to positive and more consistent earnings, which should provide the investor with price appreciation and/or a higher dividend yield.

The following characteristics typically define a high-quality company:

- Consistent earnings and dividends
- High, recurring cash flows
- High returns on capital
- Dominant competitive position
- Strong, shareholder-friendly management
- Low financial leverage

One common measure of these characteristics is Standard & Poor's Earnings and Dividend Rankings(2), which rates companies from A+ (highest) to C- (lowest) based on the growth and consistency of earnings and dividends. When one applies these rankings to the various sectors of a broad index, such as the Russell 3000 Index, observable trends are present based on the quantity of higher or lower-rated companies and the sectors in which they operate. For example, the financial services sector has a much larger relative exposure to lower-rated companies than the consumer staples sector, which has a relatively large percentage of highly-rated companies.(3) As a result of its lending operations, the financial services sector unavoidably maintains highly leveraged balance sheets while the consumer staples sector enjoys the consistent earnings that are a by-product of stable demand for their products.

Trends can also be observed when one applies these quality rankings over the market capitalization spectrum. As you may expect, the larger, more highly capitalized and established companies tend to be more highly-rated. Smaller companies have increased levels of volatility which makes maintaining consistent earnings and dividends more difficult, thus resulting in lower ratings for small-cap firms and a lower percentage of highly-rated small-cap companies relative to their large-cap counterparts3.

The secular decline in highly rated companies is also noteworthy. A-rated companies accounted for over 30 percent of all ratings in 1985, but by 2004, they only accounted for 13 percent. Over the same period, C-rated companies increased from 12 percent to 30 percent. This dramatic decline in quality across equities can largely be attributed to the increased presence of financial leverage and the corresponding increased exposure to volatility and earnings variation.

In summary, well capitalized companies in appropriate sectors of the economy are likely to outperform their smaller capitalized, more highly leveraged counterparts during turbulent economic times, i.e., those with high levels of uncertainty and volatility. As expectations increase for a persistent and volatile downturn, investors should consider pursuing a high-quality strategy to seek downside protection. Furthermore, with a diminishing number of companies possessing high-quality characteristics due to the proliferation of financial leverage, it is especially important to understand your strategic allocation to these types of investments and to frequently evaluate all of your investments and managers.

[1] Charles Schwab: A Transformational Era of Deleveraging

[2] S&P's Quality Rankings. Rankings range from A+, A, A-, B+, B, B-, C+, C, C-

[3] Rogerscasey, S&P, Barra

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Save Some Green on Going Green

The federal government and each of the states provide a variety of tax breaks and other incentives to encourage renewable energy production and energy efficiency.

These programs received a significant boost when a solar credit was included in the Emergency Economic Stabilization Act of 2008 (also known as the "Bailout Bill") and signed into law on October 3, 2008 by former President Bush. The credit has been extended by President Obama as part of the American Recovery and Reinvestment Act of 2009 (also known as the "Stimulus Bill"). Furthermore, the 2008 and 2009 Acts have dramatically improved the after-tax economics with regard to State Incentives as well in the form of Rebates/local incentives, State Credits, and local utility payments for renewable energy credits.

Federal Credit

There are two credits that concern energy efficiency for individuals: the solar credit and the credit for certain improvements, such as windows and doors, insulation, roofs, etc., for an already existing home, limited to $1,500. The solar credit provides a unique opportunity for individuals to benefit from some environmentally friendly construction on their new or existing homes, and the savings could be significant.

The tax credit is available at 30 percent of the cost, with no upper limit through 2016, for existing homes and new construction for geothermal heat pumps, solar panels, solar water heaters, small wind energy systems, and fuel cells for Residential Solar Power Electric Systems ("RSPES") installed after December 31, 2008. The credit can now also offset alternative minimum tax ("AMT") liability (reduced by other personal nonrefundable credits and the foreign

tax credit).

An individual, or the sole owner of a single-member LLC (since this structure is disregarded for federal tax purposes), would be eligible for a credit equal to 30 percent of the cost of solar panels and solar water heaters on a primary or secondary residence, a benefit not offered under the requirements of the original credit. Specifics on what requirements need to be met in order to qualify for this credit (from a building perspective) can easily be obtained from the builder.

Once the initial structure is in place, the individual would qualify for a credit of up to $1,500 to make improvements to an already existing home, as long as they are made by December 31, 2010. However, the expense of re-doing parts of a structure already in place would most likely exceed the $1,500 cap, and the individual would not qualify for a credit if the improvements are put into place during initial building or are for a secondary home, so this credit will likely capture a significantly smaller group.

Furthermore, the contractor is subject to certain credits as well for building energy efficient homes, but the home builder's credits are separate from individuals' credits and should be examined separately when reviewing an individual's or an entity's qualifications for available credits. Home builders are eligible for a $2,000 tax credit for a new energy efficient home that achieves 50 percent energy savings for heating and cooling over the 2004 Code[1]. Contractors of manufactured homes conforming to Federal Manufactured Home Construction and Safety Standards can also take advantage of this credit. There are also federal and state tax deductions for commercial buildings, with many of them at the state level.

State and Local Focus on Renewable Energy

In tandem with the federal government's extension and expansion of renewable energy credits, several states and their political subdivisions provide tax breaks and other incentives for investing in renewable energy property. The incentives offered vary depending on the jurisdiction. The most common incentives include individual and corporate income tax credits or deductions for investing in certain types of renewable energy property, sales tax and property tax exemptions for renewable energy equipment, and low-interest loans and/or grant funding for use in building renewable energy systems. These incentives may be limited in amount or by type of renewable energy property, with solar and wind production equipment gaining the most favor. In addition, many locations provide production incentives whereby owner operators may obtain preferred pricing to sell the energy produced back to the local utility.

The lack of uniformity among the states and the volume of rules and regulations prohibit a full discussion of each incentive program. We have summarized in the chart below the jurisdictions in which a variety of incentives for going green may be available.

State	Individual Tax	Corporate Tax	Sales Tax	Property Tax	Other Incentives*
Alabama	•				•
Alaska					•
Arizona	•	•	•	•	•
Arkansas					
California				•	•
Colorado			•	•	•
Connecticut			•	•	•

Delaware					•
Florida		•	•	•	•
Georgia	•	•	•		•
Hawaii	•	•			•
Idaho	•		•	•	•
Illinois				•	•
Indiana				•	•
Iowa	•	•	•	•	•
Kansas				•	•
Kentucky	•	•	•		•
Louisiana	•	•		•	•
Maine			•		•
Maryland	•	•	•	•	•
Massachusetts	•	•	•	•	•
Michigan				•	•
Minnesota			•	•	•
Mississippi					•
Missouri		•			•
Montana	•	•		•	•
Nebraska			•		•
Nevada			•	•	•
New Hampshire				•	•
New Jersey			•	•	•
New Mexico	•	•	•		•
New York	•	•	•	•	•
North Carolina	•	•	•	•	•
North Dakota	•	•		•	•
Ohio		•	•	•	•
Oklahoma		•			•
Oregon	•	•		•	•
Pennsylvania				•	•
Rhode Island	•	•	•	•	•
South Carolina	•	•	•	•	•
South Dakota				•	•
Tennessee				•	•
Texas		•		•	•
Utah	•	•	•		•
Vermont	•	•	•	•	•
Virginia				•	•
Washington			•		•
West Virginia	•	•		•	•
Wisconsin			•	•	•
Wyoming			•		•
District of Columbia					•

* Other incentives include rebates, grants, production incentives or other incentives provided for investing in renewable energy property.

[1] 2004 International Energy Conservation Code (IECC)

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Deducting State Taxes – Timing is Everything

As is often the case, tax laws written to solve one problem tend to create unexpected complexities.

Internal Revenue Code Sec. 461(d) is a case in point. This provision was enacted by Congress in the early 1960s to prevent a one-time double deduction of state taxes for federal income tax purposes. Over the course of the next five decades, this single provision has made determining the proper timing for deducting state taxes for federal income tax purposes increasingly challenging, particularly for taxpayers doing business in the state of California.

This article addresses the general rules for determining the appropriate time for an accrual basis taxpayer to accrue a deduction for state taxes and the impact of Sec. 461(d) on that accrual. It will address the counterintuitive results that Sec. 461(d) produces, especially in a corporation's final year of doing business within a state.

Background

Corporate taxpayers are entitled to a deduction for certain taxes paid or accrued during the taxable year. Such taxes include state income and franchise taxes, as well as real and personal property taxes.(1) The timing of the deduction varies depending on the method of accounting used to compute taxable income, i.e., the cash or the accrual method of accounting.(2) This article will focus on corporations that report on the accrual method of accounting.

The timing of deductions for accrual method taxpayers is generally determined by application of the "all events test" and the "economic performance test." Specifically, a deduction is allowed in the year in which all the events have occurred that establish the fact of the liability (i.e., "fix" the liability), the amount of the liability can be determined

with reasonable accuracy, and economic performance has occurred with respect to the liability.(3) If all the events have occurred to fix the liability and economic performance has occurred in a taxable year, the fact that the exact amount of the liability is not known does not prevent a taxpayer from taking the deduction in that year as long as the amount can be determined with reasonable accuracy.

When the liability is state income or franchise taxes, economic performance occurs when the tax is paid because such taxes are payment liabilities under the economic performance rules.(4) Estimated tax payments are generally included as a payment for this purpose.(5) Even if estimated taxes are not paid during the taxable year, the recurring item exception often allows a deduction for state income or franchise taxes paid within 8-1/2 months after the end of the taxable year to which they relate.(6) Thus, if state taxes are fixed and determinable at year end and are paid within 8-1/2 months after the end of the year to which they relate, an accrual method taxpayer secures a deduction for state taxes – but only if such taxes also satisfy the additional hurdle of Sec. 461(d).

The complexity of these rules makes one wonder why an additional somewhat contradictory rule on the timing of deductions for state taxes was enacted. An understanding of the historical underpinnings of Sec. 461(d) is necessary to appreciate the reason for its enactment. Before 1960, several states passed legislation that changed the lien or assessment dates for their taxes from early in one year to late in the preceding year, thus accelerating the federal tax deduction for those taxes by one year. The reason for the changes was to accelerate the assessment and collection of state taxes but the impact on the federal treasury was just the opposite. By application of the general rules regarding the timing of the state tax deduction, many taxpayers were receiving a one-time double state tax deduction on their federal income tax returns thus reducing federal taxes payable. Congress, concerned by the potential loss of revenue if similar changes were made in all fifty states, responded by enacting Sec. 461(d). The sole purpose of this provision was to prevent a one-time double deduction if a state changes its law to accelerate the lien or assessment date for state taxes. Sec. 461(d) provides that any action by a state taxing jurisdiction after December 31, 1960 to accelerate the accrual of any tax is to be disregarded and the taxpayer shall accrue the tax as if the acceleration did not occur.(7) As a consequence, the determination of the federal state tax deduction causes tax preparers to be state tax historians. Even a new taxpayer with no double-deduction is subject to these rules.

Deducting California Franchise Tax

Cal. Rev. & Tax. Code section 23151 imposes a franchise tax for the privilege of doing business as a corporation within California. Under pre-1961 California law, the tax due for the privilege of exercising the corporate franchise during the year was calculated based on the income earned during the preceding year. In other words, a continuing corporation did not have a fixed liability to pay California franchise tax with respect to income earned in Year 1 until the corporation exercised its corporate franchise in Year 2. Based on the general rules for accrual method taxpayers, a corporation may not deduct California franchise taxes for federal tax purposes until Year 2 even though the tax is calculated based on net income earned in Year 1.

Under this old law, a corporation that ceased to do business within California in a year did not have a tax liability for that final year as the corporation did not exercise its franchise the following year.(8) In 1972, California amended its franchise tax to prevent corporations from avoiding their franchise tax obligations by dissolving immediately after engaging in a profitable transaction. The effect of this law change was to fix the liability for franchise tax in the year the income was earned thereby ensuring a California taxpayer was subject to tax in its final year.

However, for federal tax purposes, this law change was considered an acceleration of time for accrual and such

acceleration was disregarded under the rules of Sec. 461(d). The accrual date for federal tax purposes could under Sec. 461(d) be no earlier than it would have been under state law as it existed at the end of 1960.

As long as the amount of California franchise tax incurred increases each year, the taxpayer need only look to the prior year's tax to determine the amount of its California state tax deduction.(9)

For a corporation doing business and paying taxes in many states, an analysis must be performed for each state to determine in which year such state taxes are deductible. While California Franchise Taxes have been the subject of most of the tax controversy surrounding Sec. 461(d), Massachusetts and Iowa real property taxes and Maryland franchise taxes have also been found to be limited by Sec. 461(d). Because of the current economic climate, we may find that additional state taxes will be limited by Sec. 461(d).

[1] IRC § 164(a)
[2] IRC § 461(a)
[3] Treas. Regs. § 1.461-1(a)(2)(i)
[4] Treas. Regs. § 1.461-4(g)(6)(i)
[5] Preamble to T.D. 8408, 57 Fed. Reg. 12411 (4/10/92)
[6] IRC §461(h)(3) and Treas. Regs. § 1.461-57 Treas. Regs. § 1.461-1(d)(1)
[7] Treas. Regs. § 1.461-1(d)(1)
[8] Rev. Rul. 2003-90
[9] IRS CCA 200629026

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Translating Foreign Activities Reporting

Every day there seems to be another newspaper article reporting IRS' epic battles over the disclosure of foreign bank accounts and the ensuing diplomatic disputes.

This media attention has greatly increased awareness of the requirement to report foreign bank and financial accounts on Form TD F 90-22.1. As a consequence, the number of these reports filed in 2009 has sky-rocketed.

However, in addition to the reporting requirements for foreign bank accounts, there are many other important information reporting obligations for U.S. persons with foreign activities that are frequently overlooked. Often even experienced tax advisors are unfamiliar with all of these filing requirements. Although these reporting obligations have not been splashed across the headlines, failure to file such reports completely and accurately can result in very harsh penalties similar to those for the failure to report foreign bank accounts. Given the heightened scrutiny by the IRS of foreign activities, it is important to briefly review some of the more frequently encountered information and reporting forms.

Form 8865, Return of U.S. Persons with Respect to Certain Foreign Partnerships, is generally required by any U.S. person who: (1) controlled a foreign partnership at any time during the year; (2) owned a 10 percent or greater interest in the foreign partnership while the partnership was controlled by other U.S. persons; (3) contributed property during the year to a foreign partnership in exchange for certain interests in the partnership or (4) had a reportable event during the year, such as certain acquisitions, dispositions or changes of proportional interest of 10 percent or greater.

Form 926, Return by a U.S. Transferor of Property to a Foreign Corporation, is generally required to be filed by any U.S. person that transferred over $100,000 to a foreign corporation during the span of 1 year, or if a U.S. person holds at least 10 percent of the total voting power or share value of the foreign corporation immediately after a transfer, regardless of the amount.

Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations, is required for U.S. persons who are officers, directors, or shareholders in certain foreign corporations if they fall within one of four categories of filers. In general, the categories include: (1) U.S. citizen or resident who is an officer or director of a foreign corporation in which a U.S. person has acquired 10 percent or more of the stock; (2) U.S. person becomes a 10 percent shareholder in a foreign corporation or disposes of stock to reduce ownership below 10 percent; (3) U.S. person who had control of a foreign corporation for at least 30 days; or (4) U.S. shareholder who owned, directly or indirectly, at least 10 percent of a controlled foreign corporation for an uninterrupted period of at least 30 days, and who owned the stock on the last day of that year.

Form 8621, Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund, is used to report certain information regarding dealings with passive foreign investment companies (PFICs). A PFIC is a foreign corporation that generates at least 75 percent of its income from passive sources or with respect to which at least 50 percent of its assets produce passive income. Generally, foreign mutual funds and offshore hedge funds are considered PFICs. Form 8621 is required to be filed by a U.S. person that received a distribution from a PFIC or recognized gain on the sale of PFIC stock. In addition, there are important elections that may be tax advantageous to the PFIC shareholder, such as the Qualified Electing Fund election, which may be made on the form. Failure to make an appropriate, timely election can significantly reduce the shareholder's after-tax investment returns.

Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts, is generally required to be filed by any U.S. person who: (1) received gifts in excess of $100,000 from a foreign person; (2) received a gift of $13,561 or more from a foreign corporation or partnership; (3) received distributions from a foreign trust; or (4) created and/or transferred property to a foreign trust;

Form 3520-A, Annual Information Return of Foreign Trust with a U.S. Owner, is generally required to be filed by the trustee of a foreign grantor trust with a U.S. owner.

The reporting obligations for U.S. persons with foreign activities are extremely complex and this is just a general overview of some of the most frequently required returns. To complicate matters there are attribution and constructive ownership rules that expand the class of individuals, trusts, and entities that are required to file many of these forms.

Given the severe potential penalties for noncompliance and the increased attention by the IRS with regard to foreign activities, it is important to completely and accurately file these returns. WTAS has an on-call team to assist you in such reporting obligations, as well as with other international tax planning opportunities.

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What “Good Governance” Means for Tax-Exempt Entities

At a recent conference at the Georgetown Law Center, recently-appointed Internal Revenue Service (IRS) TE/GE Commissioner Sarah Hall Ingram made a policy address in which she confirmed the IRS' commitment to exercising oversight of the governance practices of tax-exempt, nonprofit organizations.

The main points of Commissioner Ingram's presentation are as follows:

What IRS Perceives as "Good Governance"

Commissioner Ingram stressed that the IRS is not interested in supplanting the business judgment of a tax-exempt organization's officers or directors. To her, "good governance" refers to a series of key organizational and operational principles that the IRS has pronounced previously and that are based in the Internal Revenue Code. These include four key principles: (1) the organization should clearly and publicly express its mission; (2) the organization's board should be engaged, informed, and independent; (3) there should be in place policies and procedures intended to safeguard corporate assets (e.g., those addressing executive compensation, conflicts of interest, and independent financial review); and (4) board decision-making should be transparent, as demonstrated in contemporaneous board minutes, document retention, whistleblower protection, and the accurate, good-faith completion of the Form 990. Commissioner Ingram does not envision good governance as a "vast scheme of rules," but rather a "compact set of guiding principles." To her, there is no one-size-fits-all set of internal governance controls—but that all exempt organizations should adopt sufficient controls to minimize the risk of occurrences that would violate tax-exemption standards.

IRS Promotion of Good Governance

Commissioner Ingram identified four specific steps that the IRS is taking to help promote principles of good governance: (1) asking agents to complete a checklist at the conclusion of an examination addressing certain of the organization's governance practices and internal controls; (2) emphasizing the importance of transparency and accountability in maintaining public confidence in the integrity of exempt organizations (e.g., Part VI to the Form 990); (3) encouraging applicants for tax-exempt status to incorporate governance principles within their organizational documents; and (4) addressing specific instances of failed governance (e.g., the IRS reviews of the credit counseling industry and mortgage-assistance organizations). The Benefits of Good Governance: Following her predecessor, Steven Miller, Commissioner Ingram clearly embraces the concept that good governance is an effective tool for managing the risk of non-compliance, i.e., a well-governed organization is more likely to be a tax-compliant organization.

Guiding Administrative Principles

As it relates to corporate governance, Commissioner Ingram's tenure will be guided by the following key principles: (1) respect for the diversity of the tax-exempt sector and restraint to avoid overburdening this diversity under a mountain of rules; (2) assumption by the IRS of a "clear, unambiguous role... in governance" of tax exempt organizations using its education, outreach, and enforcement tools to accomplish this role; (3) transparency, accountability, and disclosure as important organizational tenants for tax-exempt organizations; (4) the obligation of exempt organizations to be organized and operated for an exempt purpose and the obligation of the IRS to consider how an organization is governed in determining exempt status of the organization; (5) acceptance that an organization's adoption of "a set of organizational or operational practices" does not serve to delegate the exercise of business judgment to the IRS; (6) openness to empirical evidence that a particular governance practice thought to be valuable is, instead, not valuable; and (7) recognition that Congress has never given exempt organizations and their leadership free reign but instead requires institutional safeguards against the bad practices of such organizations.

Going Forward

The IRS is planning a number of actions to review compliance with the governance principles espoused by Commissioner Ingram. One important step is to provide uniform and measured governance training to agents involved in determinations of exempt status and examination of exempt organization tax returns. The IRS will use materials developed by the nonprofit sector itself (e.g., the Panel on the Nonprofit Sector's recommended governance best practices). In addition, IRS plans to systematically review governance-related conditions that exempt-organization agents suggest to organizations undergoing examination and to applicants for tax-exempt status to ensure that they are consistent with this training. The training materials used by the IRS will be made public in a few weeks.

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