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The Taxation of Gold

Gold has unique attributes that make it attractive as an investment to many of our clients in these turbulent times and, like all investments, there will be tax ramifications to investing in gold.

Once you have determined that gold should be part of your overall investment strategy the next step is to determine what form you want to own: coins, bullion, shares of gold mining companies or exchange traded funds (ETFs). This article will look at the taxes associated with the different ways of owning gold.

Federal and State Income Taxes

Shares of stock in gold mining companies, under the Internal Revenue Code (IRC), are intangible assets and are taxed as either short-term or long-term capital assets depending on the holding period. For stocks held for more than one year the federal long-term capital gains rate is 15% in 2010, and it is scheduled to increase to 20% in 2011. The short-term capital gain rates are the same as the ordinary rates with the maximum rate at 35% in 2010, and the rate is scheduled to increase to 39.6% in 2011. For state purposes, the gain from the sale of the shares is allocated to the investor's state of residency and subject to tax in his or her home state.

Gold coins and bullion are tangible personal property under the IRC and are taxed as a collectible. Collectibles are taxed as capital gains or losses similar to stocks and bonds but with one very important exception. Collectible long-term capital gains, such as the sale of physical investment in gold, are taxed at 28% rather than 15%. However, most states do not differentiate between ordinary income and capital gains and thus apply a uniform rate to both forms of income. In states that do distinguish between ordinary income and capital gains it is important to confirm whether the state adopts or decouples from the relevant federal provisions. Further, since most states will source the gain/loss from the sale of gold (tangible personal property as opposed to intangible) to situs of the sale transaction, there may be instances where a non-resident will have a state filing and tax obligation related to a sale merely because the gold was located in that state on the transaction date. For example, if a Florida resident takes title to and stores gold in New York, any gain on the sale of that gold would be New York sourced and would be subject to tax at the applicable income tax rate (as high as 8.97%)

ETFs are taxed either as a collectible or as an intangible asset depending on the structure of the ETF. Most physically-backed metal ETFs that invest directly in precious metals are structured as an investment trust and taxed as a collectible. Investors in an ETF structured as a trust are considered to have undivided beneficial interests in the assets held by the trust. Therefore, both the sale of the ETF shares held by the investor and the sale of the metal by the trust are treated as a sale of a collectible.

Gold future contracts are taxed under the provisions of IRC Sec. 1256, and all gains and losses are taxed as 60% long-term and 40% short-term, regardless of the investors holding period, resulting in an effective 23% tax rate. This blended rate is lower than both the short-term and long-term gains rates on a direct investment in gold itself. However, Sec. 1256 future contracts must be marked-to-market at the end of the year resulting in an overall gain or loss on both the realized and unrealized gains and losses of the contracts. Most states follow the federal treatment of Sec. 1256 contracts.

State Sales Taxes

When an investor purchases shares of stock in a gold mining corporation or enters into a Sec. 1256 contract there is no state or local sales tax on the purchase. However, the purchase of gold coins or bullion could result in state sales tax depending on the state in which the sale takes place.

There is very little conformity amongst the states with respect to the taxability of gold and other precious metals. The patchwork of rules creates traps for the unwary and it is advisable to conduct review of the sales tax laws on a state-by-state basis.

For example, New York exempts the sale of precious metal bullion which includes gold bars, ingots and gold coins (except coins from the Republic of South Africa) from state and local sales tax to the extent that:

1. The total amount of the sale price on any single invoice exceeds $1,000.
2. The consideration given cannot exceed 115% of the daily closing price of gold.
3. The purchaser holds the gold in the same form as it was purchased and does not otherwise manufacture, fabricate or process the gold.

The requirement that the intrinsic value of the gold does not exceed 115% of the daily closing price of gold is designed to limit the exemption to the purchase of gold only and not to a collectible that, although may contain gold, has some other collectible or intangible value.

Connecticut's exemption for gold appears to be more stringent because it only covers instances where gold coins, bullion or legal tender are traded according to their value as precious metals; whereas the state of New York permits a 15% premium to be paid for the gold. However, as it relates to coins, Connecticut is more liberal with its exemption in that coins will be exempt from sales tax as long as they were legal tender at some point in their history.

New Jersey's exemption only applies to sales of gold provided that the sale is in fulfillment of the obligations of a contract for future delivery of gold or silver, or an option to purchase or sell such commodity, entered into on and in accordance with the rules of a licensed contract or options market.

Conclusion

When an investor decides to invest in gold it is important for the investor to understand both the tax ramifications and the different forms of investing in gold. Also, where the investor lives, where the sale takes place and where the gold is stored are equally important in understanding the tax ramifications of investing in gold.

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FASB Changes Revenue Recognition Rules: Will your Company Need to File for a Tax Accounting Method Change

New guidance was issued that will change the methodology and timing for recognizing revenue under multi-element products.

These newly adopted accounting policies may also impact a company's tax accounting methods. This article provides a summary of the changes in the book guidance for revenue recognition and also provides some insights into the impact of these changes from a tax perspective.

Overview of the GAAP Changes

In October 2009, the Financial Accounting Standards Board (FASB) finalized and issued new revenue recognition rules on *Multiple-Deliverable Revenue Arrangements* in Accounting Standard Updates ASU No. 2009-13 (EITF 08-1) and on *Certain Revenue Arrangements That Include Software Elements* in ASU No. 2009-14 (EITF 09-3). These new rules are effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15th 2010, unless entities elect to adopt it retrospectively. If an entity elects to apply these rules in an earlier interim period, the company will need to apply the guidance retrospectively from the beginning of the fiscal year.

Under prior guidance, entities selling hardware and software bundled with a service contract had to provide objective and reliable evidence of the fair value of each item sold under the contracts in order to recognize revenue separately; otherwise, they had to account for the sale as a single unit of accounting and defer the revenue until all items had been delivered, or over the term of the service contracts. The guidance of the previous revenue recognition on multiple deliverables was provided in the Emerging Issues Task Force (EITF) issue 00-21.

Comparison of the Previous and New Guidance

The key changes between the previous and new rules are outlined below.

- Under the new rules, entities are required to use a selling price hierarchy when allocating consideration to the deliverables in the multiple-element arrangement. If neither vendor specific objective evidence (VSOE) nor third party evidence (TPE) exists for the deliverables, entities then need to determine the best estimated selling price (ESP) for the deliverable. Under the previous rules, entities were required to demonstrate VSOE or TPE in order to treat the deliverables as separate units of accounting for revenue recognition purposes. Often, entities had difficulty in proving VSOE or TPE, or the fair value of each item of the deliverables.
- Under the new rules, the term "fair value" is replaced by "selling price" in order to clarify that the selling-price measure in the new rules is not a market-participant measure as required by Financial Accounting Standards Codification (ASC) 820, *Fair Value Measurements and Disclosures*. Under the previous rules, the total price of an arrangement was allocated to each unit of accounting based on their relative fair values.
- Under the new rules, the residual method has been eliminated. Once entities have determined the selling price of each item of an arrangement, the total consideration is allocated to the items based on their relative selling prices. Under the previous rules, if there was VSOE or TPE for the undelivered item within the arrangement, but not for the delivered item, the residual method was used to allocate the selling price to the

delivered item.

- Under the new rules, entities are subject to much higher levels of disclosure requirements, including the nature of its multiple-deliverable arrangements; the significant deliverables within the arrangements; the general timing of delivery or performance of service; a discussion of the factors, inputs, assumptions, and methods used to develop the selling prices, and the general timing of revenue recognition. Under the previous rules, entities just needed to disclose the description and nature of the revenue arrangements and their policy for revenue recognition.
- ASU No. 2009-14 amends the scope of SOP 97-2 (ASC 450-10-60, ASC 985-605) to exclude tangible products containing software and non-software components that operate jointly to deliver the tangible product's essential functionality. If a company sells a joint hardware/software product that meets the criteria under ASU No. 2009-14, it will now be subject to the revenue recognition rules under ASU No. 2009-13.

Overview of Tax Accounting Method Changes

From a tax perspective, a change in an accounting method for financial reporting purposes may result in a similar change in the accounting method for federal income tax purposes. In general, when an entity determines that the tax accounting method change is required due to a change in the book accounting method, they must obtain the permission from the Internal Revenue Service (IRS) National Office to change a tax accounting method by filing a Form 3115, *Application for Change in Accounting Method*. The filing procedures and timing vary depending on whether the change is automatic or subject to advance consent.

An automatic method change requires that entities send a copy of Form 3115 to the IRS National Office and also attach the original form to a timely filed federal income tax return (including extensions) for the year of change pursuant to Rev. Proc. 2008-52 and Rev. Proc. 2009-39. An advance consent method change requires that entities file a Form 3115 with the IRS National Office by the last day of the year of change and obtain advance IRS consent pursuant to Rev. Proc. 97-27 before applying the proposed accounting method to the taxable income computation. These voluntary changes in a tax accounting method generally result in an adjustment under Internal Revenue Code (IRC) Sec. 481(a). The Sec. 481(a) adjustment is computed as of the beginning of the year of change. The adjustment represents the cumulative difference between the present and proposed methods. The adjustment will either decrease (a favorable adjustment) the taxable income in the year of change or increase the taxable income (an unfavorable adjustment). Unfavorable adjustments are generally taken into account ratably over a four-year period starting with the year of change.

By filing the Form 3115, an entity receives audit protection to prevent IRS from raising the same issue for a tax year prior to the year of change. In addition, in case an entity is under IRS audit, the Form 3115 must either be filed with

the permission of the examining agent or be filed within a "90-day window period" (i.e., the first 90 days of any tax year if the entity has been under audit for at least 12 consecutive months as of the first day of the tax year) or a "120-day window period" (i.e., the first 120 days following the date an audit ends regardless of whether a subsequent audit has commenced).

The Implications of Revenue Recognition Changes on Tax Accounting Methods

Under the U.S. tax law, IRC Sec. 451(a) provides that income is recognized in the tax year in which received by the taxpayer, unless under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period. The Treasury Regulations in Reg. Sec. 1.451-1(a) also provide that under an accrual method of accounting, income is includible in gross income when all the events have occurred that fix the right to receive such income and the amount can be determined with reasonable accuracy. As such, a taxpayer receiving advance payments should include payments as income in the year of receipt; this is known as the "full inclusion" method. Alternatively, taxpayers may elect to use the deferral method under Rev. Proc. 2004-34. Under the deferral method, the taxpayer must include advance payments in gross income for the year of receipt to the extent recognized in revenue in the same year's financial statements; the remaining amount of advance payments must be included in income in the following tax year. A change to the deferral method from the full inclusion method is typically made under the automatic consent procedures.

In a recent Chief Counsel Advise (CCA) memorandum 201011009, the IRS Office of Associate Chief Counsel (Income Tax & Accounting) considered whether a taxpayer that had elected to defer advance payments under Rev. Proc. 2004-34 was required to obtain consent under IRC Sec. 446(e) if the taxpayer subsequently changed its applicable book method for deferred advance payments. The taxpayer asserted that the use of the new book method for purposes of Rev. Proc. 2004-34 should not be treated as a change in method of accounting because any omission or duplication could be avoided by making the adjustment on a cut-off basis. However, IRS concluded that the change in accounting method for advance payments for book purposes would result in a change in accounting method for income tax purposes when a taxpayer accounts for advance payments under the deferral method. The conclusion was partly based on the IRS position that the use of the cut-off method is premised on the existence of a change in method of accounting under IRC Sec. 446(e). In addition, the required method change was determined to be non-automatic, which requires that the taxpayer obtain advance consent from the IRS National Office prior to changing its method.

This conclusion by IRS presents companies who are in the process of adopting this new revenue recognition guidance with a decision. Should the company come off of the deferral method (not a desirable answer) or change to the new book method?

Either answer to this question will result in the need to file for a tax accounting method change. Therefore, for planning purposes, entities that recognize revenue under the deferral method should file a Form 3115 and obtain consent from the IRS National Office in the year that the new accounting guidance (ASU No. 2009-13 and ASU No. 2009-14) is adopted. Because this application is due before the end of the taxable year in which the financial accounting change has been made, timely filing requires careful communication and coordination between financial personnel and tax personnel at affected companies.

Because the financial accounting change generally accelerates income recognition and results in an unfavorable tax accounting method change, the resulting Sec. 481(a) adjustment (i.e., the income inclusion catch-up adjustment that is the difference between the tax accounting on the old method and new method as of the beginning of the year of change) will qualify to be spread over four years. This treatment will create a favorable timing difference that could be material for many large companies.

Practitioners complained to IRS that the requirement of filing for an advance consent method change that includes computation of a Sec. 481(a) is unnecessarily burdensome. IRS indicates it is considering other alternatives for addressing this change in method. Because the advance consent method changes are due by the end of the company's tax year, companies with this method change should be prepared to file a Form 3115 before year-end to secure advance consent to utilize the new book method for tax purposes.

Conclusion

The new accounting guidance, to the extent that it is favorable for financial reporting purposes, will be unfavorable for tax purposes. Failing to request advance consent for this change in method results in exposure that deferred income will be accelerated for tax purposes. By properly requesting advance consent, companies avoid this exposure and receive the benefit of the four-year spread for the catch-up adjustment. IRS may relax this requirement through future guidance. In the absence of such relief, companies should be prepared to file Form 3115 before year-end to reflect this change in financial accounting for tax purposes.

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Roth IRAs — Life After Conversion

In December we featured an article on ROTH IRA conversions that covered the basics of conversion. This article discusses life after that conversion, including the benefits of annual conversions.

All taxpayers are eligible to convert traditional IRAs to Roth IRAs commencing January 1, 2010. Even though all taxpayers with wage income, alimony or self-employment income (collectively referred to as "earned income") can contribute $5,000 (an additional $1,000 for taxpayers 50 or older) to a traditional IRA, they are not necessarily allowed to contribute directly to Roth IRAs; however, they are eligible to convert their traditional IRAs to Roth IRAs. With the use of a traditional IRA and nondeductible contributions, taxpayers with modified adjusted gross income

greater than the prescribed limits can in fact put money into a Roth IRA.

The contributions to Roth IRAs are limited based upon a taxpayer's income. Single taxpayers may contribute $5,000 ($6,000 in the case of 50 or older) to a Roth IRA if his or her modified adjusted gross income does not exceed $105,000. If his or her modified adjusted gross income is more than $120,000 then no amount can be contributed to a Roth IRA. If the modified adjusted gross income is between $105,000 and $120,000 then only a portion of the amount can be contributed. For married individuals, the maximum amount can be contributed to a Roth IRA only if the modified adjusted gross income reported on the joint income tax return is $167,000 or less and no contribution can be made if the reported modified adjusted gross income exceeds $177,000. A partial contribution can be made if the modified adjusted gross income is between $167,000 and $177,000.

In contrast, all taxpayers who have earned income (including alimony) can make contributions to traditional IRAs. Contributions, however, cannot be made to a traditional IRA after the taxpayer has attained age 70 ½. The issue is whether the contributions are deductible or not deductible. If a taxpayer or the taxpayer's spouse is not an active participant in a qualified retirement plan, then, regardless of the amount of income, deductible contributions can be made to a traditional IRA. However, if the taxpayer (and if the taxpayer is married - his or her spouse) is an active participant in a qualified retirement plan, then whether the contribution is deductible depends on the level of their adjusted gross income. Even if only one spouse has earned income, a contribution can be made to the IRA of the spouse who does not have earned income. A taxpayer can designate any traditional IRA contribution as a nondeductible contribution even if the contribution is otherwise deductible.

To avoid the Roth IRA income limitation, single individuals and married individuals who have income in excess of the income limits can accumulate money in a Roth IRA by first making a nondeductible contribution to a traditional IRA. After the nondeductible contribution is made to the traditional IRA, the traditional IRA is converted to a Roth IRA. By making the nondeductible contribution to the traditional IRA and then immediately converting the traditional IRA to a Roth IRA, no taxable income would generally be recognized. However, be aware that if the individual has other traditional IRAs, income will be recognized upon the conversion because all IRAs need to be aggregated when distributions are made. Part of the converted amount will include amounts from the IRA consisting of the nondeductible contributions and amounts from the other IRAs.

For individuals who are otherwise saving $5,000 per year ($6,000 if 50 or older), it could make financial sense to make nondeductible contributions followed immediately by a Roth conversion, as this will allow them to accumulate income tax free money.

These contributions can be made regardless of whether the individuals participate in a qualified retirement plan.

However, individuals who have other traditional IRAs, including simplified employee pension plans (SEPPs), may not benefit from this because all traditional IRAs have to be aggregated for purposes of determining the amount of income that is required to be recognized upon the conversion to a Roth IRA.

Assume an individual (age 35) has wages of $350,000 and the amount of the modified adjusted gross income reported on her joint income tax return with her spouse (also age 35) is $500,000. The two individuals do not have any traditional IRAs. Since their income exceeds $177,000, they are ineligible to make contributions to Roth IRAs. However, they can each make a $5,000 nondeductible contribution to a traditional IRA. After the contribution is made, the traditional IRA is converted to a Roth IRA. Since the amount converted is $5,000 and their respective basis in the traditional IRA is $5,000, no income is recognized on the conversion. If each taxpayer survives until age 80, the current year contribution will be worth approximately $45,000 (assuming a 5% investment return) at that time which can be passed on to the heirs income tax free. If each spouse made the $5,000 contribution and did the conversion every year until age 70 ½, the amount in their respective Roth IRA at age 80 would be $820,000 (consisting of $180,000 of contributions and $640,000 of investment earnings – 5% investment return). On the other hand, if each spouse were to invest the $5,000 in a taxable investment, each spouse would have approximately $347,000 less than in the Roth IRA if they were in a 35% tax bracket.

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State Tax Issues Related to Flow-Through Investments Part Two: Determining State Source Income

This article is the second 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 Three will discuss federal law that may limit a state's ability to assert a tax reporting obligation on nonresident partners. This article discusses how the flow-through entities' income is reported by the nonresident owner (corporate or individual), including

compliance and withholding issues.

Various states impose entity level taxes on flow-through entities (i.e., Michigan, Texas); however, most states "flow-through" the imposition of tax to the ultimate owners. At the flow-through entity level, the determination of state taxable income may not be as complicated; however, the challenges arise when the ultimate owners have one or more flow-through investments and must determine their own state taxable income.

Apportionment and Allocation: What Does the Flow-Through Entity Report?

When a taxpayer is doing business in several states, it has a constitutional right to have its income fairly apportioned between the taxing states. The most common method to divide the income amongst the states is by using a formula that compares the taxpayer's property, payroll and sales in a particular state with those same factors everywhere. Flow-through entities apportion their income to a state using the state specified apportionment formula. The entity is also required to notify their partners of their distributive share of state source income – generally via a state specific Form K-1.

Furthermore, flow-through entities are generally required to decide whether income is business or non-business income in order to determine the distributive share of income attributable to each state. If the income is determined to be non-business income, it will be allocated to a specific jurisdiction; whereas if it is determined to be business income, it will apportioned among the states where the entity has activity as described above.

Partner Reporting

Corporate Partners

There are three primary methods to determine state taxable income for a corporate partner. Under any of these methods, the state taxable income and ultimately the tax liability can vary significantly.

- In most states, partnership income is aggregated with the corporate partner's business income. The total business income is then apportioned using an apportionment formula that combines the corporate partner's distributive share of the partnership's apportionment factors with the corporation's own apportionment factors. In other words, the apportionment factors flow-through from the partnership to the corporate partner.
- A few states, including California and Illinois, require the flow-through of apportionment factors ***only if*** the corporate partner and the partnership are unitary. The analysis for whether a unitary relationship exists typically consists of examining three factors:

1. unity of ownership
2. unity of operation
3. unity of use

Examples of unity include common management, same line of business, and common functions such as accounting, legal, purchasing, etc.

- Other states require a corporate partner to report only its specifically allocated share of state sourced income from the state Form K-1. If the corporate partner has operations of its own in the state, it computes its own state apportioned income and adds to the result the income from the partnership's K-1.

For the partnership's non-business income, the determination of the state to which the income should be allocated will depend on the sourcing rules in the states at issue. The income will be attributed to the state or states that are considered to be the source of the income. For example, Illinois and California require that non-business income, which is determined at the partnership level, should be sourced to the state where the partner is domiciled, unless it has attained a business situs in the state. Other states may require that the non-business income be determined at the partner level, which may yield a different result in those states because the corporate investment in the partnership is treated as an intangible asset. A few states, including Arkansas, require separate allocation of a corporate partner's distributive share of income because they presume the income is non-business.

Corporate partners that engage in business with the flow-through entities in which they own an interest must also determine whether a state will require elimination of these intercompany transactions for purposes of calculating the apportionment factor. Complexities may arise when the intercompany transaction takes place indirectly or with an affiliate. In addition, some states have only specified the elimination of intercompany transactions between partners and a partnership, but have not expanded the elimination for Limited Liability Companies (LLCs) and their members.

Individuals

At the individual level, partners generally base their distributive share of income in the state on the K-1 (or equivalent) received. Generally, individuals must report all of their income in their states of residency. However, nonresident individual partners are typically taxed on their distributive share of business income derived from sources within the state. As a result of this same income being subject to tax in two or more states, the state of residency will usually provide a state tax credit for income taxes paid to the source state to mitigate the double taxation.

One often overlooked issue for nonresident individuals with flow-through investments in California is the requirement for partners who own 20% or more in a pass-through entity and whose business activity of the flow-through entity is unitary with another business activity of the partner, to determine state source income by utilizing an apportionment factor percentage.1 Similar to the method employed by corporate partners (described above), a nonresident individual partner would calculate an apportionment factor percentage by aggregating the distributive share of apportionment factors from the unitary flow-through investments.

Other issues that must be considered include passive activity losses and at-risk rules which can also limit or materially change the amount of reportable income.

Many states offer an administrative alternative to nonresident partners by allowing a flow-through entity to file a tax return and pay tax on their behalf via a composite (group) filing. Tax is generally calculated at the highest tax rate, without the benefit of possible graduated rates or exemptions/deductions. Eligible partners generally include nonresidents whose sole source of state income is the reporting pass-through entity, or if the nonresident owns multiple pass-through entities, the nonresident must be in a composite return for each pass-through entity investment in the state. In some states, a spouse's income may also jeopardize inclusion in a composite return. Although composite returns are generally only available to nonresident individuals, more and more states are allowing grantor trusts to be included in composite returns.

Tiered Partnerships

All of the above mentioned issues are also relevant when a tiered partnership structure exists. Income and apportionment factors can be flowed up through numerous levels of entities, depending upon applicable state law.

Withholding

Many states responded to the failure of partner filings and payment of income taxes on their share of state source income by implementing withholding provisions on the pass-through entity. The imposition of the withholding tax on the share of in-state income that is attributable to nonresident partners helps to ensure, and at times accelerate, the payment of tax.

States differ on the method of withholding used, though it is generally based on the amount of distributable income rather than the actual distributions. Many times this can cause a cash-flow issue for the pass-through entity. In California, withholding is required on the distributable income of non-US partners; however, it is only required of

domestic partners if a distribution was made. The states also differ on the method for remitting the withheld amounts. Some states require the payments to be remitted on an annual basis, often with the partnership return, while others require them to be made much like estimated tax payments throughout the year.

Many states that otherwise require withholding will not require it if the partner's pro rata share of income is less than a set amount, typically between $1,000 to $1,500, or if the partner elects to be included in a composite return or signs an affidavit agreeing to file a nonresident individual return.

Conclusion

The state tax treatment of flow-through entities and their owners can often result in unanticipated issues and compliance burdens. It is prudent for the entities and the owners to understand their obligations.

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

1 Regulation 17951-4(d)(4)

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Cost Segregation: A Tax Advantaged Analysis of Real Estate and Leasehold Improvements

In an economy where cash is king, more than ever before, companies can minimize their tax liability and increase their cash flow through properly classifying building and/or leasehold improvement construction or acquisition costs into lives shorter than 27 ½ and 39 years (the typical recovery period for real property).

Although results will vary depending on the type of property, the additional deductions in the first two years from a cost segregation study can total over $700,000 for every $1 million in assets reclassified from 39-year to 5-year

property. Further, the results of a cost segregation study can be used to reduce state and local property taxes, resulting in a permanent tax benefit. Finally, because cost segregation is generally associated with commercial property, any entity owning real estate or leasehold improvements can benefit from a cost segregation study—regardless of the industry.

What is Cost Segregation?

Cost segregation is an IRS recognized technique of combining tax and engineering strategies to identify and segregate the costs of "short-lived" property from real property. Short-lived assets are not always apparent. In certain instances the costs for plumbing connections, electrical infrastructure, site improvements and heating, ventilation and air conditioning systems, which would otherwise be considered real property, qualify for shorter tax recovery periods. Through a detailed and systematic accounting and engineering-based analysis, entities can be provided with substantial tax benefits in the proper identification and segregation of assets related to new construction, purchased property, remodeled/expanded property and existing real estate placed in service in prior years.

Current Tax Law: Extension of Bonus Depreciation and Qualified Leasehold Improvement Property (QLHI)

Prior legislation granted taxpayers an additional 50% bonus depreciation for property with lives of 20 years or less placed in service during 2008 and 2009. This translates into a 60% deduction of 5-year property basis in the first year.

This tax advantage is not limited to real property owners, as tenants can also benefit from a cost segregation study. If your company constructed leasehold improvements during either 2008 or 2009, very likely most of the costs (i.e., traditionally 39-year property) can qualify for 15-year tax depreciation treatment. Even better, QLHI property is also eligible for 50% bonus depreciation during these years.

The tax provisions for bonus depreciation and QLHI treatment have not yet been extended for the 2010 calendar year. On June 24, 2010, the Senate denied yet again (by a vote of 57-41) Senator Baucus' Senate Bill, "Bonus Depreciation Extension to Create Jobs Act," which would have extended bonus depreciation through December 31, 2010. This was the third substitute amendment to H.R. 4213, or "American Jobs and Closing Tax Loopholes Act of 2010," which passed in the House (by a vote of 215-204) on May 28, 2010. Only days earlier, the Senate voted 56-40 against the second amendment. While the discussions continue to ensue in the Senate, many lawmakers see the extension of bonus depreciation as a much needed tax break to both small and large businesses alike, and it is

continuing to be debated for extension.

Retroactive or "Look Back" Analysis for Assets Placed in Service in Prior Years

Conducting a thorough cost segregation study can also help to identify and properly classify short lived assets for prior year real property and leasehold construction projects, amounting to a substantial current year tax deduction. Understated depreciation from prior tax years can be taken in the current tax year by filing a Form 3115, *Change in Accounting Method,* which can be filed by the due date of a taxpayer's tax return, including extensions.

Conducting a Cost Segregation Study

WTAS cost segregation professionals recognize the time restraints that client personnel are under and our methodology is designed to minimize time and effort from clients. Significant tax benefits of a WTAS cost segregation study generally result from the following steps (as necessary):

- Review of capitalized costs and documentation
- Site inspection of the property
- Cost allocation and documentation analysis
- Asset-by-asset tax authority citation
- Computing understated depreciation and filing Form 3115 (for retroactive studies)
- Audit support

Even if an entity owns facilities purchased or constructed in prior years, a cost segregation study can be conducted retroactively. WTAS follows established and IRS-accepted engineering analyses that allows for the identification and estimation of personal property within older buildings without invoices or construction drawings.

Tax Planning

If a company is currently bidding out a construction project, or has recently engaged with a general contractor, WTAS will work with the contractors before and during construction to maximize personal property and site improvement asset classification. This offers even further opportunity to maximize short-lived property identification by analyzing the construction spending as it occurs and review of contemporaneous construction documents. WTAS can also provide electronic asset reports to allow for an upload of the study results into your fixed asset depreciation system.

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SEC to Regulate Advisors to Private Funds and Others

Among the many looming financial reforms is a requirement that managers of large hedge funds and private equity funds register as investment advisors.

Many smaller funds, family offices and venture capital firms will get some relief.

Managers of hedge funds, private equity funds, venture capital funds and family offices who have fewer than 15 clients often rely on the so-called "private advisor exemption" from registering as an investment advisor. However, Title IV of the "Dodd-Frank Wall Street Reform and Consumer Protection Act," which was signed into law this month, removes this coveted exemption, requiring advisors to private investment funds and some other private

investment advisors to register, unless alternative exemptions are available. Certain previously exempt advisors will have one year to register with the U.S. Securities and Exchange Commission (SEC), or in some cases a state regulator.

Who is Affected?

Hedge Fund and Private Equity Fund Managers — Managers who advise investment funds of $150 million or more and that would be registered investment companies but for the so-called 3c-1 or 3c-7 exemptions under the Investment Company Act of 1940 (collectively, "Private Funds") will have to register as investment advisors. Managers solely to private funds less than $150 million are exempt from registration as investment advisors, but will nonetheless be subject to upcoming SEC recordkeeping and reporting requirements.

Managers of private funds greater than $150 million will also be subject to systemic risk reporting not required by traditional registered investment advisors. For example, private fund advisors must report to the SEC their borrowings, off-balance sheet exposures, counterparty credit exposures, trading and investment positions, and other information to assess potential systemic risk and threats to U.S. financial stability. The SEC will share this information with other federal regulators to aid in assessing systemic risk.

Family Office Advisors — The legislation aims to exempt single family offices from registration. The SEC will define and exempt family offices consistently with previous exemptive policy and recognizing "the range of organizational, management, and employment structures and arrangements employed by family offices." A grandfather provision retains exemption for some family offices whose key employees invested alongside the family prior to January 1, 2010.

Based on prior exemptive orders for family offices, the SEC's family office exemption conditions might include that:

- All clients are family members, lineal or adopted descendants and their spouses, entities or charities funded and wholly-owned by family members, and trusts whose beneficiaries are family members
- Family members wholly own the advisor and hold a majority of seats on its board of directors
- The advisor was created solely to function as the family office and its fees are designed only to cover costs
- The advisor does not hold itself out to the public as providing investment advice, and does not solicit or accept non-family members as clients (possibly with isolated exceptions, such as a long-standing loyal employee)

Multi-family advisors and advisors to family assets held in a large private fund as described above may not be able to avail themselves of the family office exemption.

Venture Capital Fund Managers — Venture capital firms will be exempt from registration as investment advisors, but will nonetheless be subject to upcoming SEC recordkeeping and reporting requirements. Some anticipate that the SEC will create a narrow definition of "venture capital fund" so that other private funds cannot abuse the exemption. While purely speculative at this point, some possible limitations in the definition might include:

- Restrict to holding common shares in operating companies
- Prohibit or limit holding of debt or preferred shares
- Prohibit or limit acquiring publicly-traded securities
- Restrict the type of operating companies invested in

Depending on the definition adopted, venture capital firms might conclude that restrictions necessary to meet exemption criteria are too constrictive, and may consider registering to retain flexibility of investment approaches.

Operating as a Registered Investment Advisor

If you are required to register, your business will become more transparent to regulators, clients and the public. Most notably, your records become subject to confidential review by SEC examiners. Information about your business practices, ownership structure, client base, services offered and other disclosures become publicly available on an SEC-sponsored website. Certain advisors with investment discretion over $100 million or more of certain securities must also publicly disclose large individual securities positions. Required disclosures to clients (such as fees, types of clients serviced, types of investments and investment strategy employed, professional background, certain financial affiliates, and conflict-of-interest disclosures, as applicable) is not made public now, but the SEC did propose a rule which would make it available online.

A registered investment advisor has various ongoing requirements, restrictions, and prohibitions in its administrative and investing activities. The exact requirements can vary depending on size, activities, and complexity, but certain elements must always be present. One core requirement is a compliance program with customized written policies, designated chief compliance officer and an annual program review. The procedures should cover areas such as portfolio management, trading practices, proprietary and employee trading, accuracy of disclosures, safeguarding assets, recordkeeping, asset valuation, privacy of information, business continuity planning and marketing.

A host of other requirements or restrictions might apply, such as if you advertise performance, charge performance-based fees, have custody of client assets, use solicitors to obtain new clients, and other business

activities.

Action Steps

Private advisors facing registration should prepare well in advance, and restructuring the business model or investment vehicles may provide some regulatory relief. If registration is unavoidable, advisors should begin to develop policies and procedures, recordkeeping systems, disclosure documents and resolve staffing issues prior to the registration compliance date. Advisors should also assess whether to develop particular systems and expertise internally or through outsourcing. Vendors and consultants can assist in easing the transition into a regulated environment and provide systems or outsourcing to streamline the new compliance-related workload.

Registration and life as a registered investment advisor will add a new layer of costs and operational complexity which will vary depending on the nature of your advisory practice. However, the requirements are not onerous. Managed properly, operating as a registered investment advisor can be achieved with minimal incremental risk. It may even provide a benefit by way of increased client comfort with your operations.