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Using LIFO to Ease the Sting of Inflation

Is your business affected by rising oil or other commodity prices? If so, you may save significant income taxes by electing LIFO.

The spike in commodity prices is causing a ripple effect across the economy that is expected to trigger inflation in the prices of a broad range of products. Use of the last-in, first-out (LIFO) method of tax accounting for inventories is beneficial in an inflationary economy because it permits a taxpayer to compute a higher cost of goods sold deduction by using inflated current cost rather than a lower cost of goods sold deduction based on the lower historic cost. A higher cost of goods sold deduction produces lower margins, lower taxable income, and thus, a tax liability deferral and improved cash flow. If inflation continues for a number of years, the benefit of LIFO will increase each year as long as inventory quantities at year-end do not decline.

A company may defer the decision whether to elect LIFO until after the end of its taxable year when the benefit of the LIFO election is readily ascertainable from published indices and the quantity of goods on hand at year-end. However, for the election to be valid, the company must also use the LIFO method in preparing its financial statements for the first year of the election. The requirement that financial statements be reported on a LIFO basis for all years for which the LIFO method is used for tax purposes is the so-called “conformity rule.” Generally, this rule is violated if 12 monthly or 4 quarterly statements that aggregate to full-year performance have been issued to shareholders or creditors using a non-LIFO method. Taxpayers that are unable to make a LIFO election for 2010 due to the operation of the conformity rule may still benefit from an election for 2011. With a 2011 election, a taxpayer has ample time to plan the initial quarter in which to use the LIFO method as its financial reporting method.

The benefit of a LIFO election in 2010 can be illustrated with a simple example. Assume a company with an inventory of synthetic rubber products elects the LIFO method and chooses to use a simplified method of determining the LIFO adjustments under the Bureau of Labor Statistics (BLS) inflation index for synthetic rubber products. The inflation percentage for synthetic rubber products in 2010 was 13%. If inventory on a first-in, first out (FIFO) method at year-end is $10 million, LIFO inventory would be approximately $8.8 million and 2010 taxable income would, as a consequence, be approximately $1.2 million less. The combined federal and state tax liability at 38% would be $456,000 less, giving the company $456,000 more cash to use in its business operations. If inflation continues and inventory quantities grow, the LIFO benefit will grow each year until the company has a decrease in inventory levels (a decrement), the BLS index reflects deflation, or the LIFO election is either voluntarily or involuntarily terminated.

There are a number of reasons a company may want to terminate a LIFO election voluntarily, the most common being that the inflationary environment which initially made LIFO attractive may not continue. Companies may also find continued compliance with the conformity rule burdensome, or have other reasons for reverting to being a FIFO taxpayer. In the case of a voluntary termination, the company would not necessarily see an immediate reversal of its LIFO benefit; generally, that reversal would be spread over four years. As a result, a company that elects LIFO in the midst of an inflationary “spike” may see a cash flow benefit for years after the inflation has cooled or reversed course.

A LIFO election may be terminated involuntarily by legislative or regulatory changes. If the proposed International Financial Reporting Standards are adopted by the Financial Accounting Standards Board, LIFO may no longer be available for some or all companies. Similarly, if Congress acts to repeal or limit the use of LIFO (as it has indicated that it might do), LIFO may no longer be available for some or all companies. However, it is expected that, if LIFO were to be no longer available for either of these reasons, there would be a transition period over which LIFO benefits would be recaptured. This transition period is likely to be long enough that companies adopting LIFO in 2010 or 2011 could still achieve a discounted cash flow benefit.

On the other hand, if a LIFO election is terminated involuntarily by Internal Revenue Service because the company does not sufficiently comply with the LIFO requirements, the reversal of the LIFO benefit could be retroactive and immediate. Prior years affected by an “improper” LIFO methodology could be adjusted, and the company may be exposed to penalties and interest. The lesson: If a company wishes to avail itself of the benefits of LIFO, it must exercise due care in doing so.

A company considering a LIFO election will need to notify lenders, shareholders, employees, and other users of financial information of the change to the LIFO method and perhaps modify contracts that are based on a computation of financial reporting or taxable income. Debt covenants, bonus plans, and earn-out agreements are a few of the contracts that may be affected by a change to the LIFO method and all might require revision.

If you are considering electing the LIFO method for your business, a tax advisor can assist with estimating the potential benefit of LIFO and advising on the tax technical and business issues that result from the election. This evaluation should also consider the impact of a potential future reversal of the LIFO method. Notwithstanding the technical and business issues and the potential future reversal of the LIFO method, the short-term benefit of LIFO may be significant enough to make the election of LIFO a course of action that warrants serious consideration by businesses operating in an inflationary environment.

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Lessons Learned from a Case of Bad Debt

When taking a bad debt deduction, it matters whether you are engaged in a trade or business.

Some of the more common tax issues that taxpayers face in today's economy are those involved in debt restructurings. Whether debt is modified or cancelled on one side of the transaction, there typically is a bad debt deduction available to the lender.

For corporate taxpayers, the tax issues are relatively straightforward. By contrast, non-corporate taxpayers must first address a threshold question: Is the debt business or non-business related? A recent Tax Court case, *Dagres v. Commissioner*, 136 T.C. No. 12 (Mar. 28, 2011), sheds light on how this question might be answered, but in doing so, provided many important reminders that go beyond the determination of business versus non-business bad debt.

The case involved a typical alternative investment fund structure—more specifically, the managing member of a Limited Liability Company (LLC) that served as general partner to an investment fund. At its core, the case determined whether a loan made by the managing member to an important referral source should be characterized as a business loan or a non-business loan.

The managing member had loaned $5 million to an individual that, from time to time, had referred both potential investments and potential investors to the managing member. The taxpayer made the loan with an eye towards strengthening his relationship with the individual, who was an important source of potential income for him. After making the loan, it became clear the borrower would not be able to repay the full amount. The taxpayer wrote off a large portion of the loan, reporting a significant business bad debt deduction.

Internal Revenue Service (IRS) disallowed the deduction as a business bad debt, arguing that the debt was a non-business loan not created in connection with the taxpayer's trade or business. The managing member petitioned the Tax Court. In a thoughtful thorough decision, the court sided with the taxpayer. Ultimately looking

towards the managing member's dominant purpose, the court agreed that in making a loan to enhance and protect his trade or business as a venture capitalist, the taxpayer made a business loan that, when written off, qualified for a business bad debt deduction.

As the court explained, in the case of a business loan, the taxpayer is allowed to treat the bad debt as an ordinary loss, which is fully deductable. However, in the case of a non-business loan, the taxpayer is only allowed to treat the bad debt as a short-term capital loss. Short-term capital losses can only be used to offset capital gains, and are limited to no more than $3,000 on a joint return. Thus it is much more advantageous for a taxpayer to treat a bad debt as an ordinary loss. Therefore it is first necessary to determine whether the loan is business or non-business.

A non-business debt is defined as a debt other than a debt created or acquired in connection with a trade or business of the taxpayer. Thus, the determination of whether a loan is business or non-business depends on whether the taxpayer was engaged in a trade or business.

While the case fundamentally concerns a determination of business versus non-business bad debt deductions, several other reminders, or lessons, can be gleaned from a reading of the case.

Investing as a Trade or Business

Investing one's money and managing one's investments do not amount to a trade or business. When a taxpayer invests her own money, she is not conducting a trade or business, no matter how extensive the activity. Even when a taxpayer's entire living is earned by investment, it is still considered investing.

Nevertheless, an activity that otherwise would be a trade or business does not necessarily lose that status simply because it includes an investment function. For example, when the act of promoting, organizing, financing, and/or dealing with companies, with the immediate purpose of selling the companies at a profit rises to a level of a business, it remains a business even when the individual involved is investing his or her own money.

In the case of many alternative investment funds, the role of the fund's general partner is that of promoting, organizing, financing, and/or dealing with the fund's investments with the immediate purpose of selling the investments at a profit. In other words, the fund's general partner is engaged in a trade or business. That a general partner invests some of her own money does not change the fact that the general partner is engaged in a trade or business.

Managing Others' Investments as a Trade or Business

As stated by the court, the manager of an investment fund (similar to any bank or brokerage firm that invests other people's money) provides a service that is an investment mechanism for the customer but that is a trade or business of the manager. In exchange for this service, the manager receives fees and a profits interest. Importantly, neither the nature of the profits interest, nor its treatment as capital gain make it any less compensation for services.

Managers of investment funds work continuously and regularly in investing fund money to grow companies. They actively participate in the growth and development of portfolio companies. They also design and implement exit strategies for the recovery of the investors' equity and any profit. Like a stockbroker or a financial planner, the manager of an investment fund receives compensation for the services rendered to the fund's investors and neither a co-investment by the manager, nor the characterization of the profits interest as capital gain changes the nature of the manager's trade or business.

The Trade or Business of a Partnership Generally Is Imputed to its Partners

Notwithstanding IRS guidance to the contrary, a general partner generally is deemed to be conducting the trade or business activity of the partnership of which she is a member. So, too, then is the managing member of a LLC. Accordingly, in the case before the court, having determined that the general partner (a LLC) was engaged in a trade or business of managing others' investments then the taxpayer, as the managing member of the LLC, was also deemed to be engaged in that trade or business.

As suggested, the case provides more than just an answer to the business versus non-business bad debt question presented. The case provides important reminders that serve as the basis for potential tax-savings opportunities or important tax pitfalls for the uninformed.

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Is that K-1 Income Subject to Self Employment Tax?

It is late spring and you receive a K-1 from a Limited Liability Company (LLC) in which you are a member. On line 14 of the K-1, there is a number being reported to you: self-employment earnings.

Is it correct? Should you be reporting your share of LLC income as self-employment earnings? If you do, you now have an additional tax to pay, called the self-employment tax. This self-employment tax is imposed in addition to the regular income tax you already pay, and is imposed on your self-employment earnings. The self-employment tax rate for self-employment earnings is generally 15.3%. However, for 2011, the rate is reduced to 13.3%.

Generally, a taxpayer's share of ordinary income reported on a Schedule K-1 from a partnership engaged in a trade or business is subject to the self-employment tax. However, like any general rule, there are a myriad of exceptions, including one excepting a limited partner's share of ordinary income from a partnership. Should the term "limited partner" be interpreted to include members of a LLC? How about partners in a Limited Liability Partnership (LLP)?

When Congress added the exception some 30 years ago, it did not define "limited partner." Arguably, no definition was needed. Limited partner essentially meant one thing under most states' laws – a partner enjoying limited liability who did not participate in the management or control of the partnership. However, the legal landscape has changed since Congress added the exception and some would argue the tax landscape needs to catch up.

What legal changes have taken place? First, revised partnership statutes in most states have redefined the term limited partner to expand significantly the extent to which such a partner may participate in the control or activities of the partnership without jeopardizing the partner's limited liability. Second, all states have added at least two new

types of legal entities since the exception found its way into the Internal Revenue Code: LLCs and LLPs. While there are similarities between LLCs, LLPs, and traditional limited partnerships, the comparison is far from exact.

In a LLC, each member enjoys limited liability. Depending on the type of LLC (i.e., member-managed versus manager-managed), as well as provisions of the operating agreement, members are free to participate in the control and activities of the LLC to any extent.

LLPs arose as a means of protecting professionals from the liability of their partners engaging in negligent acts. Unlike a limited partnership, there is no need in a LLP for a general partner that remains wholly liable for the liabilities of the partnership; rather, each partner remains liable only for his or her own acts. In some states, the privilege of operating within the LLP form is reserved to certain professions (e.g., lawyers, doctors, architects, etc.) but in all cases, the partners of a LLP are free to participate in the control and activities of the entity without jeopardizing their liability protection.

Applying the term “limited partner” in the changing legal landscape has proven to be a vexing issue for Internal Revenue Service (IRS). Despite two sets of proposed regulations, still no definitive meaning exists. Following its last regulatory effort, numerous taxpayers complained that the Department of Treasury (Treasury) had overstepped its regulatory authority in defining “limited partner.” Congress agreed and imposed a one-year moratorium on the finalization of any regulations. The Senate went so far as to pass a resolution urging Treasury to withdraw its proposed regulations. And while the moratorium has long since passed, neither Treasury nor IRS have offered a revised proposal.

Informally, attorneys within IRS have suggested that taxpayers following the latest proposed regulations will not be challenged upon audit. In practice, some taxpayers and practitioners do rely on the proposed regulations while others rely on an acceptable interpretation of the term “limited partner” found in the statute.

In a recent Tax Court case involving a LLP, the taxpayers relied on such an interpretation. They argued that since they enjoyed limited liability as partners within a LLP, they fell within the intended definition of limited partner. Using its own statutory interpretation, the Tax Court found that the intent of the limited partner exception was to ensure that taxpayers who merely invested in a partnership did not receive credits towards Social Security coverage. In other words, Congressional intent did not support the argument that Congress meant to exclude partners who performed services for a partnership in their capacity as partners (i.e., acting in the manner of self-employed persons). Accordingly, the Court held that the taxpayers’ income from the LLP constituted self-employment earnings and should be reported on line 14 of their K-1s.

So what is the right answer to the question of whether ordinary income on a K-1 constitutes self-employment earnings? Perhaps the reason why Congress, Treasury, IRS and Courts have found this to be such a vexing issue is that finding the right answer is so highly dependent on the facts and circumstances of each case. The recent Tax Court case seems to have focused on the nature of the taxpayer’s activities, and not on the title “limited,” or the liability protection enjoyed. In determining self-employment earnings, it would seem that, such a tack is appropriate. Unfortunately, it means that absent Congress coming forth with some bright-line definition, each situation will need to be analyzed carefully to determine whether the income constitutes self-employment earnings.

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Section 409A Valuation Considerations

Overview of Internal Revenue Code Section 409A

Section 409A regulates the treatment of nonqualified deferred compensation (NQDC) paid by a “service recipient” to a “service provider” for federal income tax purposes. Sec. 409A has a measurable impact on the way NQDC plans are designed and operated. Failure to adhere to Sec. 409A could result in immediate taxation, a 20% penalty and potential interest payments to the employee. The context in which most commonly encounter Sec. 409A regulations is related to the issuance of employee stock options and other equity instruments.

When issuing stock options, companies must be aware of the following requirements of 409A:

1. the fair market value must be determined using “reasonable application of a reasonable valuation method;” and
2. a valuation needs to be performed by someone qualified to perform such a valuation, based on her knowledge, training, experience, etc. (In most cases, companies choose to hire outside appraisal firms to meet this requirement); and
3. the valuation needs to be updated at least every 12 months, or more frequently if significant changes occur in the business between grant dates (e.g., new rounds of financing, new product launches, new major customers, etc).

409A Valuation Checklist

In order to comply with 409A, a company may hire a third-party appraiser to perform a valuation. This valuation will ultimately be reviewed by several parties, which could include management, Internal Revenue Service, the company's auditors or even the SEC. The following represents a non-exhaustive checklist of items that you, as a reviewer of the appraisal, may want to consider.

- Is the appraiser qualified?
  - Does the appraiser have previous experience performing 409A valuations? If not, does the appraiser have significant valuation experience that would suggest his/her competency? Has the appraiser's work been successfully reviewed by auditors?
- Is the valuation date recent to the grant date?
  - Is the valuation date no more than 12 months prior to the grant date for the options?
  - Have any significant events occurred between the valuation date and the grant date that might affect value?
- Is the appraiser employing appropriate methodologies to value the common stock? There are generally two steps involved with this type of analysis.
  - The first step involves determining the overall company value.
  - The second step involves allocating the total company value among the various capital owners (e.g., preferred and common shareholders). As outlined in the American Institute of Certified Public Accountants (AICPA) guidelines, the three most commonly used valuation methodologies for the second step are the option-pricing model, probability weighted expected return model and the current value method. Note, the current value method is only appropriate in limited circumstances.
- Does the appraiser support his/her concluded marketability discount using evidence other than quantitative methods?
  - Many appraisers rely solely on quantitative methods such as put option models to quantify the marketability discount in a 409A analysis; however, IRS will look for evidence beyond quantitative models (e.g., an analysis of restricted stock studies) to support the concluded discount.
- Did the appraiser consider any recent rounds of financing or recent transactions of the company's common stock?
  - Has the company had a recent round of financing that it views as arms-length and indicative of fair market value? If so, the appraiser will need to consider the round of financing in the valuation, and may need to rely on the pricing of the round to deduce the common stock value.
  - The secondary transaction market has grown considerably over the last few years, and private company common stock is increasingly being traded over secondary exchanges or otherwise sold to private buyers. The appraiser will need to consider whether this transaction is a relevant indication of value, which can be driven by factors such as the motivations of the buyer and seller, the block size, the level of due diligence performed and other factors.
- Can the valuation be used for both tax reporting and financial reporting purposes?
  - If you intend to use the appraisal to support your Accounting Standards Codification Topic 718 stock compensation expense (formerly known as SFAS 123R), the appraisal needs to state that it is valid for both tax and financial reporting purposes.

Primary Factors that Influence Common Stock Value

There are a number of factors that impact a company's common stock value. While the magnitude and directional impact of these factors can vary depending on a company's capital structure, stage of development, etc., these

factors generally have the following impact on value:

- Company Value: Any factor that increases the overall company value (e.g., faster growth or greater profitability) will increase the common stock value.
- Preferred Stock Participation Feature: Most preferred shares contain a conversion option that allows the owner to convert his/her preferred shares into common shares. Some preferred shares, however, have a participation feature allowing them to share in any upside with the common shares without the exercise of the embedded conversion rights (i.e., “they get to have their cake and eat it too”). The presence of this type of participation feature ultimately increases the value of the preferred shares and reduces the value of the common shares.
- Preferred Stock Cumulative Dividends: When a company has preferred stock with cumulative dividends, a larger portion of any sale/initial public offering proceeds will be distributed to preferred stock, thereby reducing the remaining value available to the common stock.
- Sale or Transfer Restrictions: The presence of sale/transfer restrictions associated with the company’s common stock will reduce the stock’s attractiveness and, therefore, reduce its value.
- Control or Voting Rights: In most cases, a single share of common stock does not have significant control or voting rights. The presence of any material control or voting rights will increase the value of the common stock.

Conclusion

Although IRS has not invested significant resources reviewing 409A appraisals to date, IRS has recently indicated that they now intend to focus on 409A valuations. Obtaining a defensible appraisal is an important step in potentially saving you and your employees from unnecessary IRS challenges and penalties.

View our article, "Why you should care about 409A valuations," in *VentureBeat*.

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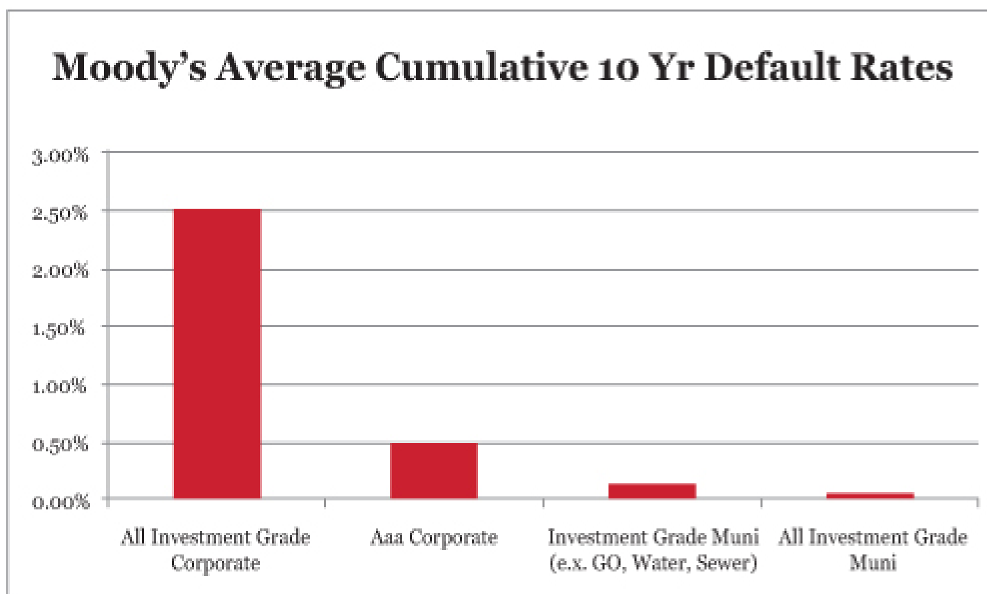
Revisiting Municipal Bonds

As the overall economy showed signs of improvement in the fourth quarter of 2010 and into 2011, the municipal bond market continued to struggle.

An increase in mutual fund redemptions that drove prices lower was caused in part by relentless negative media attention regarding credit ratings and potential defaults. Investor fear was fueled by Wall Street analyst Meredith Whitney's *60 Minutes* appearance in December where she commented, "You could see 50 sizable defaults. Fifty to one hundred sizable defaults. More. This will amount to hundreds of billions of dollars worth of defaults." As the press piled on, increasing the fear of defaults, prices in the fourth quarter suffered their worst decline in 16 years.

However, given the historically low default rates in municipal bonds (as illustrated below) as well as their ability to diversify risk and improve after tax return in portfolios, it is an especially important time to revisit municipal bonds. Bonds, like any investment strategy, carry risk and require skill and discipline when committing funds into the market.



Source: Moody's via Breckinridge Capital Advisors.

One of the most attractive features of municipal bonds is the exemption of their interest payments from regular federal income taxes. Muni bonds can be purchased that are also exempt from federal alternative minimum tax (AMT); and most state and local governments will not impose tax on municipal bond interest paid on their own bonds. In early February, the average yield on the 20 long-term munis that make up the Bond Buyer index was 5.3%. An investor in the 35% federal income tax bracket would need to earn 8.1% interest from a taxable bond to get an equivalent return. At the time, 30-year Treasury bonds were yielding 4.5% (April, Kiplinger Personal Finance). If individual tax rates increase, the tax benefit of owning municipal bonds will only improve.

Muni bond pricing, for both short and long maturities, has become more attractive with the increased fear over state finances and credit ratings. The increased sales pressure on municipal bonds has caused yields to rise (yields move inversely to price of bonds). However, as noted in the chart, muni issuers rarely default. This is due in part because public entities have the power to tax in order to meet interest and principal payments. For many states, payment of general obligation bonds is a constitutional priority. Some astute investors (including Pimco's Bill Gross) are buying municipal tax-free bonds in taxable bond funds because of the relative attractiveness in the current marketplace.

Municipal bonds, like other interest bearing bonds, are sensitive to both rising interest rates and inflation. Whether investing via mutual funds or buying individual bonds, it is critical for an investor to understand interest risk, time horizon and duration. Duration is the measure of a bond or bond fund's sensitivity to interest rate shifts (rising and falling). In uncertain times such as these, many professional money managers will manage interest rates and reinvestment risk by minimizing duration. If a fund has an average duration of 5 years, it means that its price of the fund should move about 5% for every 1% move in interest rates. The lower the duration, the less sensitive the portfolio to interest rate movements. The average duration for most mutual bond funds is published by Morningstar.

Individual or self-directed investors often employ "buy and hold" or, a laddered bond strategy. Unfortunately, individuals buying municipal bonds are often subject to thin and/or inefficient markets. In short, they may experience poor pricing or mark-ups because they lack the purchasing power of larger institutional investors—one potential benefit of hiring a professional money manager. Individuals should inquire about any mark-ups on bonds and the opportunity to participate in block pricing. For more information on recent municipal bond trades and pricing, please see the site www.investinginbonds.com.

Another potential benefit of utilizing an institutional or professional money manager to invest in municipal bonds is they typically will employ a full team of credit analysts to further research a specific municipality's ability to make interest and principal payments. Given the current market conditions, detailed credit research and analysis of the specific issue and issuer is critical.

Bonds are an integral part of a well balanced asset allocation strategy. Each class of bonds from corporate to mortgage-backed to U.S. treasury bonds has unique risk/return characteristics and benefits to an investor. Municipal bonds can diversify your portfolio and provide federally tax-free income, the latter being a unique quality to municipal bonds. Like any investment being reviewed for inclusion in your portfolio, it is important to understand the reason for investing in municipal bonds, how they might fit into your portfolio, the time horizon for holding them, and the most effective way to access them. A lot of market noise surrounds municipal bonds at the current time (which can serve to create appealing opportunities for investors). We suggest revisiting the fundamentals of municipal bonds with your advisors to decide if they are an appropriate strategy for you.

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Business Activity Tax Simplification Act of 2011

On April 8, 2011, House of Representatives Bill 1439, the Business Activity Tax Simplification Act of 2011 (The Bill) was introduced to Congress. This proposed legislation seeks to modify the following three areas of state taxation: (1) the application of Public Law 86-272; (2) the physical presence nexus standard; and (3) the calculation of tax liability in group returns.

If passed, The Bill would be effective as of January 1, 2012, and could have a significant impact on many taxpayers' multistate filing obligations.

Revision of P.L. 86-272

Currently, Public Law 86-272 (hereinafter referred to as P.L. 86-272) generally prohibits the imposition of state *net income tax* if a taxpayer's activities within a state are limited to the solicitation of orders of tangible personal property, which are sent outside the state for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the state.

The proposed "modernization" would expand the applicability of P.L. 86-272 to other business taxes, which The Bill defines as net income taxes or "taxes measured by the amount of, or economic results of, business or related activity conducted in the State." This does not include sales and use tax or transaction taxes.

P.L. 86-272 currently applies only to the solicitation of orders of tangible personal property. However, The Bill would expand the protection of P.L. 86-272 to include solicitation of orders of "other forms of property, services,

and other transactions" and to the solicitation of customers "for sales or transactions."

In addition, the proposed house bill aims to encompass business activities beyond the mere solicitation of orders within the scope of P.L. 86-272 protection. Specifically, the bill expands protection to:

1. the furnishing of information to customers or affiliates and the coverage of events or other gathering of information, if the information is used or disseminated from a point outside the state; and
2. those business activities directly related to the potential or actual purchase of goods or services if the final decision to purchase is made outside the state.

The expansion of P.L 86-272 to other business taxes and sales of other forms of property, service and other transactions could provide benefit to a large population of taxpayers. Because the protection of P.L. 86-272 is currently limited to taxes based on net income and the solicitation of sales of tangible personal property, those taxpayers which stand to benefit the most would be those taxpayers that are in industries which involve solicitation of sales of intangibles and/or services doing business in states which impose business taxes.

Physical Presence Standard

The Bill would create a physical presence requirement in order for states to have the power to impose, assess, or collect a net income tax or other business activity tax. "Physical presence" exists if:

1. an individual is physically in the state, or there is at least one or more employees assigned to the state;
2. services of an agent (excluding an employee) are utilized to establish or maintain the market in a state, if such agent does not perform business services in the state for any other person during such taxable year; or
3. a business leases or owns tangible or real property in a state (tangible personal property does not include the leasing or licensing of computer software).

A de minimis presence exception is also provided in The Bill. Excluded from the definition of "physical presence" is presence in a state for less than 15 days in the taxable year and presence in a state to conduct limited or transient business activity. It is important to note that both "limited" and "transient business activity" are not defined in the proposed house bill.

Group Returns

The last section of The Bill addresses group returns and applies to states which consider the net income or economic results of affiliated persons in the calculation of tax liability. This section provides specific rules for the calculation of combined net income, consolidated net income or other economic results where an apportionment formula is utilized. An apportionment formula generally measures a taxpayer's state presence in the form of a percentage, by weighting the taxpayer's state property, payroll and sales. Generally for group returns, the apportionment factors include the numerator and denominator of each member included in the group return, regardless of whether each member has nexus in the state or not. The Bill provides that the apportionment formula denominators shall still include the aggregate factors of those group members whose net income or other economic results are included in such combined or consolidated net income or other economic results; however, the numerator shall include the factors attributable to the state of only those persons that are themselves subject to taxation by the state. Although some states currently adopt this type of rule, known as the "*Joyce*" standard, others do not; and this rule would

provide uniformity among states which require group returns.

WTAS Commentary

Clearly, the impetus behind the proposed house bill truly is simplification. Not only does the bill establish a bright-line physical presence standard, but it is also taxpayer friendly with its revisions to P.L. 86-272 and the group return rules. The bright-line physical presence standard provides benefit to taxpayers that have a presence of less than 15 days in a state or conduct limited or transient business activity in a state. As mentioned above, there is a broad spectrum of taxpayers that could benefit from the bill's revisions to P.L. 86-272 – specifically taxpayers that solicit orders for services and intangible property, as well as taxpayers that solicit sales in states that impose gross income or gross receipt taxes. Moreover, the adoption of the "*Joyce*" standard in group returns provides benefit to those taxpayers with affiliated members that lack nexus in unitary combined and consolidated filing states.

Given the taxpayer friendly nature of The Bill, it likely faces stiff opposition in Congress. In prior years, similar legislation made it to a House of Representative floor vote, but did not advance beyond that point. A hearing for the proposed bill occurred on April 13, 2011. Subsequent to the hearing, stakeholders and advocacy groups issued opinion statements on the bill. As expected, these groups fell out on both sides of the issue creating uncertainty for the bill's future. The Federation of Tax Administrators issued a statement opposing the bill, while members of the Tax Foundation and International Franchise Association were in favor. These varied responses to The Act likely reflect opinions of those in Congress that will ultimately determine the bill's fate.

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2011 California Nexus Expansion

As we indicated in the December 2010 edition of the newsletter, California's nexus requirements have changed as of January 1, 2011.

The requirements have expanded the definition of nexus to include "economic nexus," and thereby subjecting more taxpayers to California's minimum tax, and possibly to, income taxes or Limited Liability Company (LLC) fees. Specifically, taxpayers will be considered to be doing business in California if any of the following conditions are satisfied:

1. they engage in any transaction for financial or pecuniary gain within California; or
2. they are organized or commercially domiciled in California; or
3. annual sales in California exceed the lesser of $500,000 or 25% of total sales; or
4. the value of real and tangible personal property in California exceed the lesser of $50,000 or 25% of total property; or
5. payroll in California exceeds the lesser of $50,000 or 25% of the total payroll.

When determining the amount of the taxpayer's sales, property, and payroll for purposes of doing business, the taxpayer's pro rata share of sales, property and payroll from partnerships, LLCs treated as partnerships, and S corporations are included. Partners and members are considered doing business in California if the partnership or LLC is doing business in California. Similarly, a partnership or LLC is considered doing business if the entity has general partners or members doing business in California.

California has recently outlined a number of scenarios under which a taxpayer might have nexus. For example, a corporation might find itself with nexus because it meets one of three new provisions, such as having over $500,000 in sales in California or over 25% of its sales in California. It might also have nexus if it's pro rata share of sales, property or payroll of a partnership (in which it has a limited partnership interest) exceeds the limits set out in the new provisions. A corporation that has its own sales, property, or payroll, as well as a pro rata share of sales, property, or payroll from an interest in a partnership, would aggregate such to determine whether it has nexus. The same is true of upper-tier partnerships, which would have to aggregate all of the property, payroll, and sales of lower-tier partnerships to determine whether nexus exists.

A partnership could have nexus by virtue of the fact that it has employees working from their homes providing warranty work to California customers, even though the property, payroll and sales fall below the thresholds. Nexus is found because the employees are "actively engaging" in transactions for profit on behalf of the partnership.

These changes to the nexus requirements could result in out-of-state taxpayers being subject to California's minimum tax, (which is imposed on the privilege of doing business), while still being protected under Public Law 86-272 and, thereby not being subject to California taxes based on income. Likewise, because different sourcing rules apply for purposes of determining the apportionment of income, taxpayers may not be subject to California's income tax if none of its income is apportioned to California under these rules, yet would still be subject to the minimum tax.

In addition, the State's recent switch to the "market rule" for sourcing of services, which sources receipts based on the location of the purchaser, could result in an out-of-state service provider being subject to tax in California even though it has no property or payroll in California and all of the services are performed outside of California.

Now is the time to review the potential impact that these new nexus provisions could have on your company's California filing requirements.

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Michigan 2011 Tax Amnesty Update

The Michigan Department of Treasury (MDT) has recently issued details relating to the 2011 Tax Amnesty Program which runs from May 15, 2011, through June 30, 2011.

The tax amnesty allows Michigan taxpayers a process to resolve tax liabilities with the MDT for return periods ending on or before December 31, 2009, and avoid the typical penalty payments associated with under or non-reported tax liabilities. Taxpayers accepted into the program also avoid civil and criminal penalties and possible prosecution by the MDT. To participate in the program, qualified taxpayers must complete amnesty application and make full payment of the tax liability, including interest, by June 30, 2011, to be eligible. The following provides some additional details regarding the program.

Program Eligibility

Tax amnesty is available to both individual and business taxpayers who have tax liabilities for eligible taxes for return periods ending on or before December 31, 2009. Tax liabilities include under or non-reported tax liabilities, overstated deductions, credits or exemptions, unregistered taxpayers who have failed to file Michigan tax returns, delinquent payment of past due taxes and taxpayers who have received a final tax due notice. Individuals and business taxpayers are not eligible for the amnesty if they are:

1. eligible to enter into a Voluntary Disclosure Agreement (VDA) with the state;
2. the subject of a current tax-related Court of Claims case;

3. under criminal investigation or involved in a civil action or criminal prosecution for that tax; and/or
4. convicted of a felony under the Revenue Act or the Internal Revenue Code.

Program Eligibility - Audits, Informal Conferences and Litigation

To participate in the program if taxpayers are under audit, taxpayers must remit the full amount of the tax due, including interest, and submit a completed application to MDT during the specified amnesty period. Although the audit will include any applicable penalty, it will be waived at the time the audit is processed. For audits that will not be completed by the end of the amnesty period, taxpayers may prepare and submit amended returns and an application and remit full payment of the tax and interest due to the auditor during the tax amnesty period. Applicable penalty would only be applied to any additional tax determined due upon completion of the audit.

Tax amnesty is also available for taxpayers who are in the informal conference process. Taxpayers must submit the application and full payment of the tax and interest by June 30, 2011; the informal conference process will proceed as it normally would.

Taxpayers can also participate if they are litigating a case before the Michigan Tax Tribunal or the Appellate Courts by submitting the application and the full tax and interest by June 30, 2011. Taxpayers may continue litigating their case before the Michigan Tax Tribunal or their appeal before the Appellate Courts if the tax amnesty is granted. However, taxpayers that have already paid the tax, interest and penalty that they are contesting in order to litigate in the Court of Claims is not eligible for the amnesty.

Qualifying Taxes

Taxes covered by the amnesty program include all state taxes administered under the Revenue Act (PA 122 of 1941). These include: the income tax; the Michigan Business Tax; the Single Business Tax; sales and use taxes; withholding tax; fuel and motor carrier taxes; IFTA fuel tax; airport parking tax; convention facilities tax; cigarette and tobacco taxes; tobacco equity assessments; estate tax; inheritance tax; intangibles tax; retaliatory tax; severance tax; and the real estate transfer tax.

Tax obligations not covered by the amnesty include the above taxes for return periods ending after December 31, 2009, and local taxes (e.g., city, county), including real and personal property taxes. Furthermore, amnesty is not available if the tax is attributable to income derived from a criminal act.

Participation Requirements

In order to participate in the Michigan Tax Amnesty Program, taxpayers must submit: a completed Tax Amnesty Application (Form 3855); all un-filed or amended tax returns for which the taxpayer is requesting amnesty; a completed Registration for Michigan Taxes (Form 518), if the applicant is a business taxpayer and the business is not registered; and full payment of all tax and interest due. The Tax Amnesty Application, applicable returns, and full payment (including interest) must be postmarked no later than June 30, 2011, to qualify.

The Department of Treasury will notify taxpayers in writing if the request for amnesty has been denied. Tax amnesty may be denied for:

1. not filing the required returns or remitting the required payment of tax and interest; and/or
2. not submitting returns and payments for periods covered by the amnesty; and/or

3. not filing the Tax Amnesty Application by the deadline of June 30, 2011; and/or
4. not fully completing a Tax Amnesty Application.

If amnesty is denied, civil penalties will not be waived and criminal prosecution may be sought.

WTAS professionals can assist Michigan taxpayers during the amnesty period by assessing qualification for the program, preparing the relevant amnesty applications, quantifying exposures, preparing tax returns and in some cases even attempting to settle issues directly with the Michigan Department of Treasury. Likewise, our professionals can also assist companies for which a VDA may be more beneficial choice. If you or your company may benefit from the Michigan Tax Amnesty, please contact your WTAS advisor as soon as possible.

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Beverly Hills Estate Planning Council Event

On March 7, 2011, the Beverly Hills Estate Planning Council (BHEPC) welcomed WTAS' Susan Amster and Deborah McGee as speakers. Before a sold out crowd, Amster and McGee presented a case study on estate planning entitled, "All of the King's Men – The Family Office Team."

In their 70-minute presentation, Amster and McGee defined family office, shared details of a factual four-generation family they served and illustrated the successful estate planning results.

McGee presented first and assured the crowd that if they have seen one family office, they in fact have seen *only one family office*. She described a variety of family office infrastructures, including ones designed and built to serve an individual's or a family's wealth using an outsourced model. This virtual family office infrastructure involves many professionals working together, including attorneys, insurance professionals, CPAs, valuation professionals and wealth advisors with one (often the one responsible for procuring the client and assembling the team) serving in a quarterback role. McGee also covered current topics and trends in family offices including: (1) families' increased focus on their vulnerability to fraud; (2) a discussion of how the SEC's ultimate definition of family office may still require certain complex family offices to register as Investment Advisors; and (3) a general trend toward "skinning down" in many family offices via outsourcing, simplification of structures and processes, and technology investments.

Amster continued with a presentation on her team approach to an estate plan for a multi-generational family office with net worth in excess of $100 million. The family had charitable inclinations and through the team's planning, they were transferring wealth from generation one to generation four using generation-skipping tax (GST) exemptions and GST trusts while also funding a private foundation with the annuity payments from two charitable lead annuity trusts (CLATs) funded by generation one. The first CLAT was an inter-vivos CLAT that sold its remainder interest to a GST trust funded by generation two for the benefit of generation four. The second CLAT was a testamentary CLAT funded upon the death of generation one, with input from generation two who would inherit the assets. Both CLATs paid an annual annuity to a private foundation formed by generation two. Additional family planning involved transfer of wealth from generation two to generation three via a series of rolling two-year "zero-out" GRATs, with the excess appreciation at termination of the GRATs passing to generation three through a

grantor trust. Finally, in or around 2008, generation two hoped to pass wealth to generation three through a sale to an intentionally defective grantor trust (IDGT) with a family limited partnership (FLP) holding real estate (that could be sold and developed); however, the real estate market crash did not enable this planning to fruition.

Many members of the BHEPC applauded the advanced planning as innovative and educational. Several noted that it is seldom they engage in planning at this level and thus appreciated the knowledge. In the end, Amster and McGee contributed to the BHEPC's spirit of professional excellence and succeeded in sharing how "All of the King's Men" must work together in an effort to serve the estate planning clientele. Please see www.bhepc.org for more details.

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