Deficits, Politics and Policy: a Tax Legislative Outlook

Accounting Methods and ETR Planning

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Audit . Tax . Consulting . Financial Advisory.

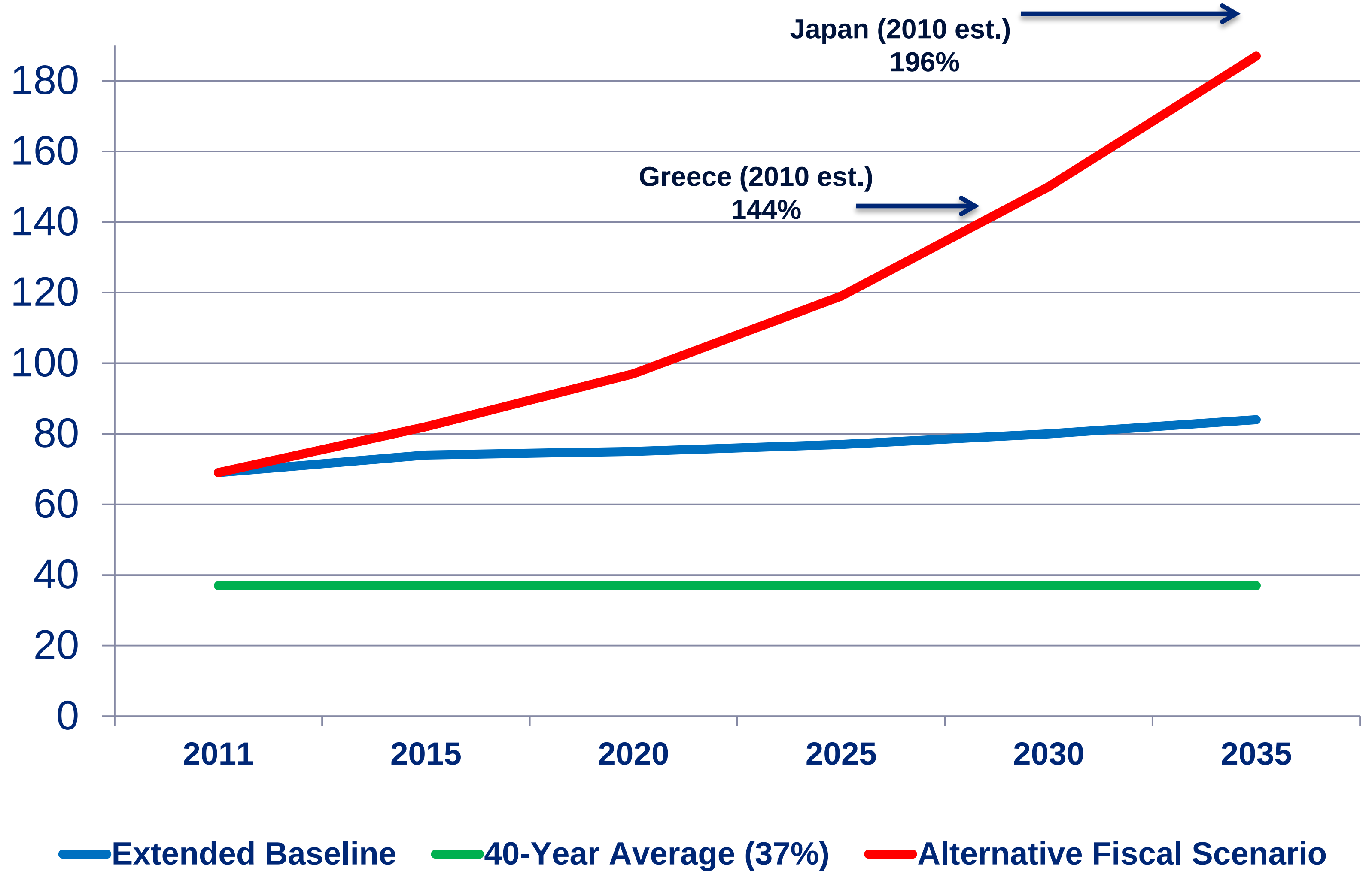
Agenda

- Debt, Deficits and Demographics
- The “supercommittee” Cure?
- Current State of Affairs
- Tax Reform Debate
- Opportunities!!

Debt, Deficits and Demographics

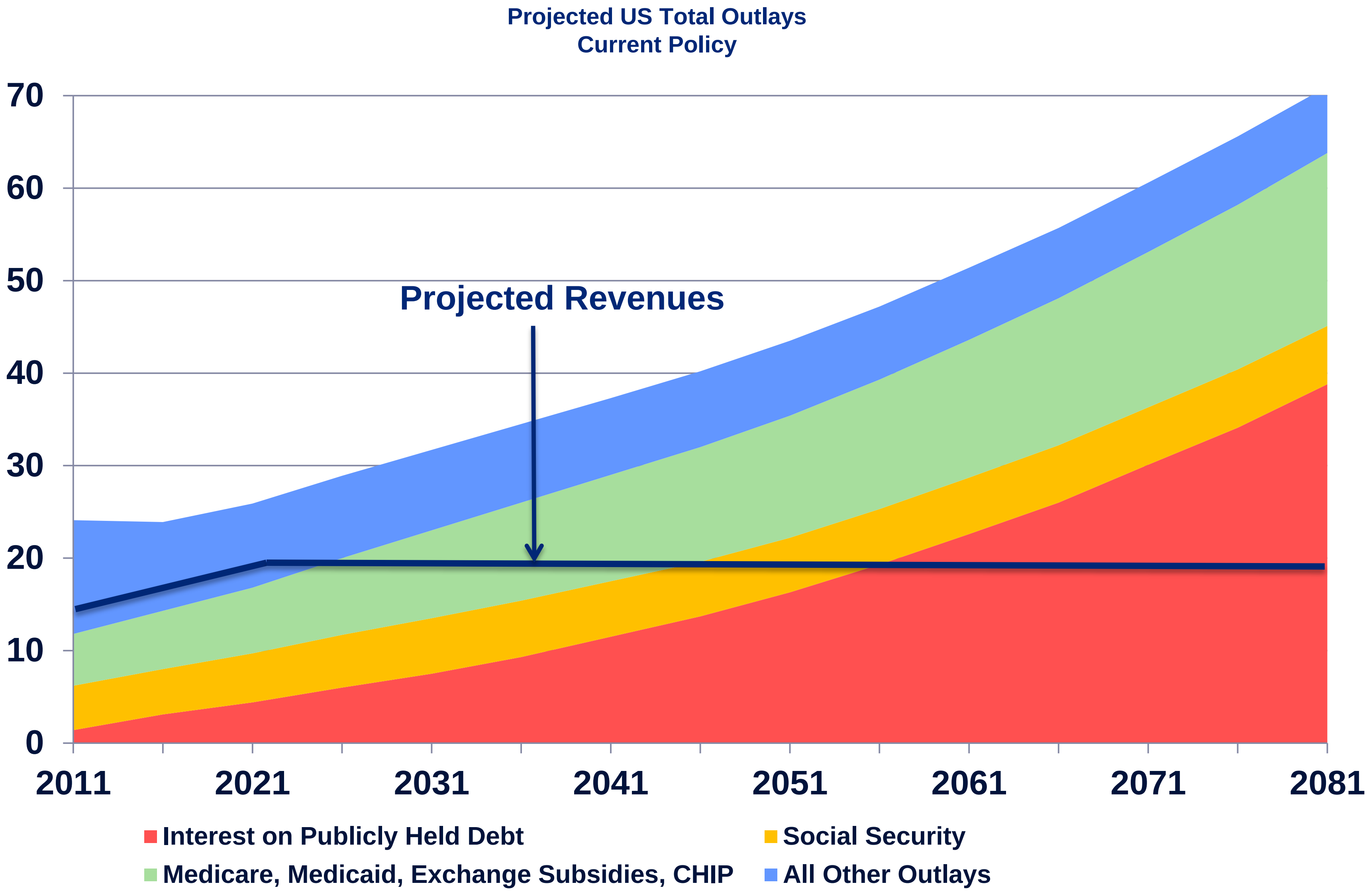
Federal Debt Held by the Public

(as a percentage of GDP)



Source: Congressional Budget Office, *CBO's 2011 Long-Term Budget Outlook* (June, 2011)

The Revenue/Spending Squeeze



Source: Congressional Budget Office, *CBO's 2011 Long-Term Budget Outlook* (June, 2011)

The “supercommittee” Cure?

Budget Control Act of 2011

- Created the bipartisan, bicameral Joint Select Committee on Deficit Reduction (i.e., the "supercommittee")
- 12-member supercommittee tasked with recommending an additional deficit reduction package of at least $1.5 trillion over 10 years
- Enforced by "trigger" which cuts spending $1.2 trillion if supercommittee deadlocks or Congress fails to enact supercommittee's recommendations
- Budget Control Act may trade a debt limit crisis today for a debt limit ***and*** tax crisis later
  - The Act ensures the debt limit is sufficiently raised to carry the government until the end of 2012
  - Expiring after 2012: Current tax rates on individual income, capital gains, and dividends; current estate tax exemption and top rate; AMT patch
  - Effective in 2013: Taxes on upper-income taxpayers enacted as part of healthcare reform, including the 3.8% Medicare surtax on investment income and .9% increase in the employee portion of the Medicare HI tax

Current State of Affairs

2013 Individual Tax Law Changes

- Expiring after 2012 (if no action is taken by congress)
  - Current tax rates on individual income
  - Capital gains and dividends
  - Current estate tax exemption and top rate
  - AMT patch and expired/expiring tax provisions
- Effective in 2013 Taxes on upper-income taxpayers enacted as part of healthcare reform
  - 3.8% Medicare surtax on investment income
  - .9% increase in the employee portion of the Medicare HI tax

Current Tax Rate Landscape – post 2012 (absent congressional action)

Top Tax Rates	Current Law through 2012	Beginning 2013
Ordinary Income	35 %	39.6%
Dividends	15%	39.6%
Long-term capital gains	15%	20%
Health care reform increases	None	.9 percent – ordinary income 3.8 percent – investment income
PEP & Pease limitations	Gone	Restored
Estate and Gift tax	35% top rate; $5 million exemption	Returns to pre-2001 55% top rate $1 million exemption

Where are we today

- Whitehouse
  - Revenue increase of $1.6 trillion dollars over 10 years from increase tax rates
  - $400M-$600M in spending cuts
  - Democrats want Republicans to propose spending cuts plan

- House Democrats may try to force vote on legislation that passed in Senate which reduced rates for those making less than $200K (filing separately) and $250K (Filing Jointly)

- Sides remain far apart

Tax Reform Debate

Tax reform – conventional wisdom

- There is consensus that comprehensive tax reform is necessary
- A consensus that rates need to come down, to be paid for with largely yet-to-be determined base broadening
- A top corporate rate in the 25 percent range coupled with a move to a territorial tax system

Tax Expenditures

- What is a tax expenditure?

  "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability"

  Or, more simply,

  Almost anything on your tax return that you like

- Tax expenditure cost differs from revenue estimate

Largest Corporate Tax Expenditures

Largest Corporate* Revenue Raisers	JCT Revenue Estimates over 10 yrs. ($ billions)
MACRS	$506.8
Expensing of R&E expenditures	$152.2
Deduction for income attributable to domestic production activities	$127.0
Inventory methods and valuation: LIFO & LCM	$65.6
Credit for low income housing	$33.0
Deferral of gain on like-kind exchanges	$16.0
Completed contract rules method	$13.9
Energy related expenditures	$12.3
Subtotal	**$926.8**
Total of all business expenditures estimated	**$964.3**
Revenue-neutral corporate income tax rate	**28%**

Does not include revenue impact of changing tax treatment for pass-through entities

White House Framework

Corporations

- Reduce corporate tax rate to 28 percent (eliminate many tax expenditures)
- Tighten current worldwide system rather than adopt territorial

Individuals and estates

- Pre-2001 ordinary income rates for high-income taxpayers (on July 9, called for 1-year extension of current law rates only for taxpayers earning below $200/$250K)
- Higher capitals gains & qualified dividends tax rates
- Buffett rule (30 percent millionaire’s AMT)
- Tax carried interest as ordinary income
- Permanent 2009 estate and gift tax structure (45%, $3.5 M)

Major tax reform plans: Lower rates, fewer expenditures

Proposal	Expenditures repealed	Corporate rate	Individual rate
White House framework	Many corporate	28% (lower for manufacturing)	n/a
Rep. Camp's discussion draft	Implicitly all corporate	25%	n/a
Rep. Ryan's FY2013 budget	Implicitly all	25%	Two brackets: 10% 25%
Bowles-Simpson	All corporate and all or many individual	26% - 28%	23% - 28%
Senate "Gang of Six"	Many corporate and individual; reform others	23% - 29%	Three brackets: 8-12% 14-22% 23-29%

Outlook for tax reform

- Taxwriting committees continue to hold reform hearings (international, financial products, debt vs. equity, etc.)
- Camp's tax reform discussion draft is an important first step, but leaves out some significant details
- Business should remain vigilant, but tax reform likely delayed until at least 2013

Opportunities

Opportunities

- Corporate Planning
  - Dividend payments before Y/E
  - Income Deferral
  - Accelerate Deduction
  - Loss Triggers

- S-Corporations- Consideration of electing to distribute out of historic E&P (if applicable)

- Private Company estate planning

- Planning for pass-through entities and Individuals
  - Accelerate income
  - Defer deductions
  - Accelerate recognition of capital gains

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Planning for Increasing Rates: Corporate Tax Payers

- Monetization transactions
  - **Distributions (2012 and later)**
  - **Shareholder sale (Exit planning)**
  - **Dividend planning**
  - **Current distribution of cash**
  - **Recapitalization transactions – Debt funded distribution**
  - **Distribution of note**

- Exit planning
  - **IPO**
  - **Strategic acquisitions**
  - **Redemptions**
  - **Shareholder sales of shares**

- Other transactions
  - **Partial liquidations**
  - **IRC § 355 transactions**

Qualifying Dividend Income – IRC §1(h)(11)

- Qualifying dividend income (“QDI”) taxed at either 0% or 15%.
- Expiring provision, currently enacted through December 31, 2012.
  - Preferential rate also applies to AMT. IRC § 55(b)(3)(B).
- QDI is added to “net capital gain.” IRC § 1(h)(11)(A).
  - QDI does not offset net capital loss

Dividend Planning – Lump Sum Distributions

In an “increasing tax rate” environment.

- A corporation that makes regular annual dividends can achieve tax efficiency by “bunching” dividends prior to a tax rate increase.
  - A corporation with currently low cash balances, but steady annual cash flow.
  - A corporation with no accumulated or current E&P that anticipates generating E&P in the near term.
  - A corporation with no accumulated E&P and minimal current E&P that anticipates annual future E&P.
  - A corporation with low accumulated or current E&P ahead of an anticipated gain recognition event.

- An S corporation with former C corporation E&P that desires to distribute the accumulated C corporation E&P all at one time (noting an economic difference between a “deemed” distribution of C corporation E&P and an actual distribution of C corporation E&P).

Dividend Planning: Distributing a Corporation's Note

When might it make sense for a corporation to make a distribution of its own note from a dividend planning perspective?

- How will the distribution of a corporation's own obligation be classified?
- Dividend today or dividend tomorrow?
- How to measure the amount of the distribution?
- What are the annual effects of such a distribution?
- What are the tax return reporting issues?

Example : Cash Dividend -4 years

	Year 1	Year 2	Year 3	Year 4	Total
Dividend	1000	1000	1000	1000	4000
Tax Rate	15%	40%	40%	40%	
S/H Tax	150	400	400	400	1350
Net Cash	850	600	600	600	2650

Example : Dividend of a $3k Note and $1k Cash

	Year 1	Year 2	Year 3	Year 4	Total
Dividend	4000	0	0	0	4000
Tax Rate	15%	40%	40%	40%	
S/H Tax	600	0	0	0	600
Net Cash	400	1000	1000	1000	3400
Note Bal.	3000	2000	1000	0	

Debt Funded Distributions/ Recapitalizations

- Large lump sum distribution in 2012
  - Distribution of excess cash
  - Debt funded distribution
- Corporations that regularly make distributions may recapitalize and make 2012 distribution funded with additional leverage.
  - Cash flow that otherwise would be distributed to shareholders would fund debt service.
  - Allows for benefit of 2012 rates on QDI if qualifies
- Exit planning
  - M&A and IPO
  - Borrowings from debt funded distribution can be repaid with IPO proceeds
  - Shareholders obtain partial monetization in 2012 at current rates.

Other Transaction Planning

- Strategic transactions
  - Sale transactions
  - Joint ventures

- IPO planning
  - Secondary offering

- Other transactions
  - Redemption planning
  - Partial liquidations
  - Spin-off planning

- Earnings and profits

Accounting Methods to Defer Income and Accelerate Deductions

Claiming Losses for Impaired Assets

- The recession has negatively impacted taxpayers businesses and they have taken impairment charges on their financial statements attributable to fixed assets used in their business.
- In general, a taxpayer is allowed to claim losses on depreciable business property only when there is a sale, exchange or physical abandonment of the property.
- However, in some instances losses can also be taken when impaired non producing assets are transferred to a scrap account.

Accelerating Depreciation for "Lag"

Depreciation begins, for federal income tax purposes, when property is first placed in a "condition or state of readiness" and is available for its specifically assigned purpose or function.

- *Treas. Reg. § 1.167(a)-11(e)(1)(i).*

- Generally, for tax purposes, it is not essential that an asset actually be put into use in the taxpayer's trade or business before beginning depreciation.

Accelerating Depreciation for "Lag"

The final regulations make it clear that a change in placed-in-service date is <u>not</u> a change in method of accounting. *Treas. Reg. § 1.446-1(e)(2)(ii)(d)(3)(v).*

- In cases where cost recovery is initiated in a year later than appropriate, amended returns must be filed for open tax years to accelerate the cost recovery.

- In cases where an asset is in a non-depreciable "suspense account" in a year later than appropriate, the regulations indicate that a change in method of accounting is appropriate as a "non-depreciable to depreciable" change.
  - ⇨ Automatic 3115 under Rev. Proc. 2011-14.

- In certain cases, a Construction Work In-Progress (CWIP) account may be considered a suspense account, resulting in a section 481(a) adjustment.

Deducting Repair Costs

- Taxpayers commonly misclassify deductible repair costs as capital expenditures for tax purposes

- Expenditures are properly deductible in the tax year incurred as incidental repairs if they are ordinary and necessary, do not appreciably prolong the useful life, alter the use, or materially increase the value of property

*** Repair deductions should consider the Improvement and Routine Maintenance Safe Harbor rules under the Tangible Property Regulations (i.e. taxpayers "may apply" in 2012 and 2013; effective date Jan 1, 2014)*

Deducting Repair Costs

Potential Application

Taxpayers who

- Currently capitalize expenditures made to maintain existing operations, equipment, and infrastructure (such as repairs, maintenance, rehabilitation, refurbishment, rebuilding, replacement of component parts, etc.)
- Are in the retail, manufacturing, utility, oil & gas, or other industry that is capital intensive or has a high level of fixed assets

Deducting Prepaid Expenses

Facts

- Many taxpayers follow financial statement treatment for prepaid expenses (such as insurance, maintenance, licenses and miscellaneous expenses) by capitalizing these costs and recovering them ratably over the period to which they relate

Application

- Deduct certain prepaid expenses (such as payment liabilities like insurance) for the tax year of prepayment if the underlying coverage period is 12 months or less
- Automatic Change- Rev. Proc. 2011-14, and 2006-12

Deferring Income Recognition of Disputed Sales

Facts

- Taxpayers may have customers that dispute amounts billed for various reasons (e.g., clerical error, poor quality, incorrect quantity, etc.) and short-pay the invoiced amount in these cases

Potential Application

- Exclude disputed amounts from taxable income in the tax year the sales transaction occurred since there is not a "fixed right" to receive the income
- Factual issue does not require a method change, may be changed on an amended return.

Deducting Bad Debt

Facts

- Many taxpayers defer tax deductions for wholly and partially worthless receivables until the specific debt has been written off for financial statement purposes

Potential Application

- Deduct worthless receivables under IRC § 166 where a specific reserve for wholly or partially worthless debt is maintained and the amount can be substantiated

Implementation

- Generally does not require a change in accounting method; decrease current taxable income or increase NOL carryback

Accelerating Deduction of Incurred but not Reported Self-Insured Medical Expenses

Facts

- For financial statement purposes, taxpayers generally establish reserves for the estimated liability of self-insured medical claims that will be paid to employees or medical service providers
- For tax purposes, taxpayers often deduct incurred but not reported ("IBNR") self-insured medical claims in the year payment is made to an employee or medical service provider, in the year a claim is approved or in the year a claim is filed

Accelerating Deduction of Incurred but not Reported Self-Insured Medical Expenses

Potential Application

- Deduct self-insured medical expenses associated with medical claims submitted by third-party medical service providers for the tax year the medical services are rendered
- To the extent that claims are filed by employees (for out-of-network costs or for other reasons) a taxpayer's liability is not "fixed" until the employee files the claim
- IBNR within Worker's Compensation Accruals
- **Implementation**
- Requires a change in method of accounting to be filed on Form 3115 under the automatic consent procedures of Rev. Proc. 2011-14

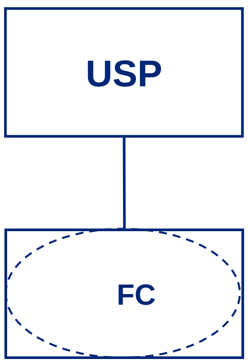
Loss Triggers

Worthless Stock Planning

Consider

- Transferring expected future losses from foreign subsidiaries to the U.S.
- Transferring losses back to another legal entity for state tax planning purposes
- Securing a worthless stock deduction
  - ⇨ Conversion to a disregarded entity is an "identifiable event" for purposes of IRC § 165(g)(3) (see Rev. Rul. 2003-125)
  - ⇨ Other criteria under IRC § 165(g)(3) must be met
  - ⇨ Special rules for consolidated return filers

IRC § 165(g)(3) Worthless Stock Deductions



FC elects to be treated as a branch

*Reportable transaction disclosure if loss of $10M or more

Facts

- FC is a foreign operating company that is insolvent (liabilities in excess of assets)

Requirements to obtain a §165(g)(3) deduction

- **Certain stock ownership and gross receipts tests must be met**
- The stock that USP owns in FC must have basis
- Security must not have been worthless prior to the year in which worthlessness is being claimed
- The security became worthless in the year claimed
  - *Morton v. Commissioner*, established a two-part test for the finding of worthlessness of stock
  - Stock must cease to have liquidating value
  - There is no "reasonable hope and expectation" that the stock would become valuable at some point in the future
- There must be an identifiable event
  - Rev. Rul. 2003-125 recognizes a check-the-box election as an identifiable event

Inventory Opportunities

Subnormal Goods

- Treas. Reg. § 1.471-2(c) authorizes write down to net realizable value
- To qualify, goods must be unsalable at normal prices or unusable in the normal way

Normal Goods

- Cost
- Lower of cost or market
  - ⇨ GAAP rules and Tax rules are different

Other Considerations

- Interaction with foreign tax credits
- Interaction with section 199
- Consolidated return issues
- Multistate issues
- CERT rules
- Future Income
- Financial statement ramifications

Planning for Flow-Through Entities Expecting Increases in Tax Rates at the Investor Level

Operating Partnerships and Flow- Throughs

Professional Services Firms, Investment Managers, Other Flow-Through Operating Businesses

- Owners of these businesses will be impacted by the rate changes
  - Top rate on high income earners of 35% versus top rate of 39.6%, plus 0.9% HI increase results in 5.5% rate differential on most ordinary income over $250,000
  - Need to consider impacts on the owners and measure those carefully
- Model out the impacts of increasing income in 2012 versus picking up the income in later years
  - Use cash flow models with various assumptions, interest rates, discount rates, etc.
  - Compare amount of after-tax proceeds the owners would have with and without the acceleration over some period of time
  - Counsel using disciplined approach to these decisions

Flow-Through Planning (Cont)

- Consider accelerating income or deferring deductions
  - Method changes, depreciation methods, elective deferrals
  - Repair and Maintenance Temporary Regulations-Elections may be made to capitalize certain assets and increase income
  - Consider election out of bonus depreciation
  - IRC § 481(a) elections to correct incorrect or borderline methods
- Defer income
  - Consider unwinding income deferrals
  - Other method changes
  - Note differences for cash method taxpayers
- As noted earlier, S corporations with prior C corporation E&P should consider making a distribution that will be considered a dividend of E&P
  - S corporations can make an election to treat distributions as dividends to the extent of E&P instead of exhausting AAA

Changing Facts/Elections:

Defer :	Consider:	Elect:
• Prepaying liabilities • Making charitable contributions • Funding of pension or defined benefit plans • Paying bonuses until later than 2 ½ months after year-end	• Placed-in-service date and review fixed asset accounting methods • Sale-leaseback transactions • Ability to forgo deductions under IRC §§ 162, 163, and 167 (period expenses only)	• Under Treas. Reg. § 1.263(a)-4(f)(7) not to apply the 12-month rule to similar items incurred during the tax year (e.g., prepaid expenses including insurance, warranty, and service contracts) • Out of bonus depreciation and elect ADS lives for current year additions • Under IRC § 59(e) to capitalize research & development costs − Will also increase net FSI since it reduces the allocation of R&D to FSI in the current year − Can be designated dollar amount • Under IRC § 266 to capitalize taxes and carrying charges

Changing Methods

Change from lower of cost or market (LCM)

Minimize last-in, first-out (LIFO) deduction

Change to more disadvantageous UNICAP methods; Consider U.S. ratio method (Notice 88-104) or Interest capitalization using substitute cost method (Notice 88-99)

Remediate exposures (e.g., bad debt, inventory, warranty, or other expense reserve deductions and bonus plan deductions)

Current inclusion of advance payments (vs. deferral under Rev. Proc. 2004-34 or Treas. Reg. § 1.451-5); Cost of sales offset not required (PLR 200638015)

Capitalize: package design costs, certain R&E expenses (under IRC § 174(b)), and/or software development costs (vs. expense under Rev. Proc. 2000-50)

Change from percentage of completion method to accrual method for services (where billings exceed earnings under PCM)

Defer rents - increasing rents (generally straight-line accounting for book purposes)

Review and implement all applicable unfavorable changes in Rev. Proc. 2011-14

IRC § 59(e): Optional 10-Year Writeoff of Certain Tax Preferences

- Election to capitalize qualified expenditures and amortize over 10-years, beginning with taxable year expenditure is incurred
- Qualified expenditures include amounts deductible under:

IRC §	Expenditure
173	Circulation (Note: Amortize over 3 years)
174(a)	Research and experimental
263(c)	Intangible drilling and development (Note: Amortize over 5 years)
616(a)	Development
617(a)	Mining exploration

- Election statement must:
  - Be attached to timely filed original return (including extensions) for taxable year in which the expenditure is incurred
  - Include the type and amount of qualified expenditures that the taxpayer elects to capitalize/amortize (can be a portion of the qualified expenditures)
- Election is made at partner or S Corp shareholder level
- Revocation of election will be granted by IRS only in rare and unusual circumstances

IRC § 266: Election to Capitalize Taxes and Carrying Charges

- Under Treas. Reg. § 1.266-1(b), depending on type of property (real, personal, unimproved or unproductive real property), may apply to: interest on loan/mortgage, certain taxes, carrying charges, and certain necessary expenditures
- If election is made, it applies to all expenses of that type for a particular project
- Election is effective only for year for which it is made and for certain property is effective until construction complete or until put into use by taxpayer
- Election statement must:
  - Be attached to timely filed original return (including extensions) for taxable year in which the election is made
  - Include the item or items the taxpayer elects to treat as chargeable to a capital account
- UNICAP is applied before IRC § 266

Election out of Bonus Depreciation

Example: $7M asset (office furniture, fixtures & equipment, class #00.11)

$M (rounded)	Yr 1	2	3	4	5	6	7	8	9	10	11
100% Bonus	$(7)M										
MACRS	(1)M	(1.7)	(1.2)	(0.9)	(0.6)	(0.6)	(0.6)	(0.4)			
MACRS SL	(0.5)M	(1)	(1)	(1)	(1)	(1)	(1)	(0.5)			
ADS	(0.35)M	(0.7)	(0.7)	(0.7)	(0.7)	(0.7)	(0.7)	(0.7)	(0.7)	(0.7)	(0.35)

- Elect out of bonus
- Elect MACRS straight line or ADS:

MACRS Straight Line
IRC § 168(b)(5) & IRC § 168(b)(3)(D)

Alternative Depreciation System (ADS)
IRC § 168(g)(7)

Elect on Form 4562
Irrevocable
Class by class election
Automatic 9100 relief
IRS Publication 946

Choice of Legal Entity

- Is it time to consider incorporating certain operating businesses and possibly certain investment income generating entities and paying lower rate?
  - Individual rate on operating income may increase to effectively 40.5% for operating income and 43.4% for certain investment income
  - Corporate income tax rate will remain at 35% absent corporate tax reform
  - Earnings would be retained and exit would be by way of stock sales or redemptions, which result in single layer of tax at lower LTCG rates
  - The differential could be even greater if corporate tax reform occurs while the individual tax rates remain unchanged

- Possible issues with the Accumulated Earnings Tax and the Personal Holding Company Tax

Question and Answer

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