



A Fresh Look: Improving Your Chances for Investment Success



After six straight years of market gains, the financial markets' recent correction provides an opportunity to reevaluate your portfolio and determine how well you are positioned to meet your unique investment goals.

A portfolio review examines your overall investment plan and can uncover and address any weaknesses in your portfolio that might prevent you from achieving your goals.

In the aftermath of the last financial crisis, many investors hold assets at multiple financial institutions, furthering the need for regular, high-level portfolio assessments. To evaluate the whole portfolio, it is critical to consider all accounts as part of one investment plan, regardless of where assets are held. Portfolio reviews can help mitigate risk by identifying overlap across multiple advisors and investments that could cause excess exposure to a single security, sector, region, or currency.

In the current low-return environment across multiple asset classes, it is particularly important for investors to focus on the factors within their control: strategic asset allocation, investment selection, fees, and taxes. Conducting

a portfolio review provides a fresh look that can help investors optimize their portfolios for any market environment.

The Key to Investment Success – Asset Allocation

A strategic asset allocation aims to achieve optimal risk-adjusted return by diversifying across multiple asset classes, such as stocks and bonds. Seminal studies have indicated that about 90% of variability in returns is attributable to strategic policy decisions, rather than security selection. Long-term investors should consider their individual goals, risk tolerance, and investment timeframe when making this critical asset allocation decision. Once the asset allocation plan is determined, it is crucial to stick with that plan regardless of short-term market movements.

One of the most common potential mistakes that investors make is allowing current market conditions and emotions to dictate allocation decisions. Bull markets tend to make investors aggressive and bear markets make them apprehensive. Many investors put 100% of their portfolios in Dot-Com stocks leading up to the market peak in 1999, and piled into gold and cash during the lows of 2009. Adhering to your investment plan and rebalancing regularly so that your portfolio never strays too far from its asset allocation will prevent emotional decision making. Rebalancing also trims exposure to areas that have done well, and adds to those that have done poorly, forcing you to sell high and buy low.

Investment Selection

Irrespective of the investment vehicle used (mutual funds, managers, ETFs or individual securities), it is important to conduct due diligence and periodically evaluate holdings. Some key considerations when selecting mutual funds and managers are the long-term track record, experience of the management team, and investment philosophy. The portfolio review process can help investors to clarify what they are trying to accomplish with their investments and decide whether their current investment plan is appropriate for their risk preferences and investment objectives. Current market conditions should also be taken into consideration when evaluating investments. For example, an investor should be aware of not only the amount of bonds in his or her portfolio, but also the type of bonds. A conservative portfolio with a 75% allocation to high quality bonds could still be quite risky if those bonds had durations of 30+ years because of the interest-rate risk on longer-duration bonds.

Impact of Fees & Taxes on Portfolio Performance

Over the long run, paying attention to fees and taxes can have a noticeable impact on your total return. This is particularly important in the current environment where expected returns in most asset classes are low. It is crucial to assess your investment returns net of fees. Portfolio reviews will evaluate total fees, including advisory fees and fees on the underlying investments, to help you determine if you are overpaying for your portfolio. Although high fees and taxes can erode your performance significantly over time, there are actions you can take to mitigate them as much as possible.

Simple tax strategies to consider include holding period management (holding securities for longer than one year to benefit from the lower long-term capital gains tax rates), tax loss harvesting (assuming the intention is not to continue holding the position), and charitable gifting of highly appreciated securities. A portfolio review should not only consider asset allocation, but also asset location. If appropriate, high-income-generating assets could be held in tax-deferred retirement accounts; a traditional IRA could be rolled over to a Roth IRA to avoid tax on future retirement distributions; and assets could be placed in various types of trusts to reduce estate taxes. Coordinating

tax and investment strategy can result in significant tax savings that can help you achieve your financial goals.

Conclusion

During this period of heightened market volatility, now is an opportune time to reevaluate your portfolio. An objective portfolio review can help you clarify your financial goals and ensure that your portfolio is positioned well to meet them. While markets are unpredictable, ensuring that your portfolio has an appropriate asset allocation, low fees, and is tax-efficient will better position you for any market environment.



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UK Tax Update: Major Changes on the Way



On July 8, 2015, the Chancellor of the Exchequer, George Osborne, presented the UK Summer Budget to Parliament.

While there were many reforms included in the budget, our discussion here will be limited to the following changes that are of particular interest to our existing high net worth individual clients with UK connections:

- The abolishment of the non-domiciled (non-dom) status for long-term residents;
- A change in the taxation of UK sourced dividends; and
- Inheritance tax on all real property situated within the UK irrespective of ownership form.

Permanent Non-Dom Status Abolished, Effective April 2017

Non-dom taxpayers in the UK were historically given the option of using a remittance basis of taxation by paying a remittance basis charge (RBC), which could be as high as £90,000 for long-term residents (defined as individuals living in the UK for 17 or more years out of the most recent 20 tax years). The remittance basis of taxation is an

alternative to being taxed on an arising basis under UK tax rules, which is similar in concept to U.S. taxation of worldwide income of its citizens and green-card holders. For non-dom individuals with significant income sources and gains outside of the UK, it may have been advantageous to annually pay the RBC rather than paying tax on worldwide income on an arising basis.

However, starting in 2017, individuals who have been UK residents for more than 15 of the past 20 tax years but are foreign domiciled under general law will be deemed domiciled in the UK for all tax purposes (i.e. income, capital gains, inheritance taxes). As part of this new regime, once a taxpayer acquires domicile (or is deemed to be domiciled) in the UK, the individual will only be able to lose their UK domicile by exiting the UK for a period of more than five years prior to re-acquiring residency in the UK. If at a later date (having spent more than five tax years abroad) the non-dom returns to the UK for a period of time but does not intend to permanently stay, they will remain foreign domiciled under general law and will be able to spend another 15 years as a resident for tax purposes before again becoming deemed domiciled in the UK. The following tables illustrate the changing RBC guidelines:

Residency Period	Annual RBC (current law)	Annual RBC (April 6, 2017)
Fewer than seven out of the prior nine years	Nil	Nil
At least seven, but fewer than 12 years	£ 30,000	£ 30,000
At least 12, but fewer than 15 years	£ 60,000	£ 60,000
At least 15, but fewer than 17 years	£ 60,000	Ineligible for RBC
17 or more years	£ 90,000	Ineligible for RBC

Taxation of UK Dividends

Starting April 6, 2016, the dividend tax credit system will be replaced by a dividend income allowance of £5,000. New rates will also be introduced as part of this new regime. The new dividend tax rates in effect next year will be higher: 7.5% for basic rate taxpayers, 32.5% for higher rate taxpayers, and 38.1% for additional rate taxpayers. While these rates remain below the main rates of income tax, those who receive significant dividend income will pay more according to the Budget Report submitted.

Inheritance Taxes on Real Property Situated Within the UK

Under current rules, if a non-dom individual dies owning UK property directly, their estate is subject to inheritance tax (IHT) at 40% on the value of that UK property. It is irrelevant whether the deceased was resident in the UK. Once a non-dom becomes UK domiciled or deemed domiciled for IHT purposes, their worldwide assets become subject to the IHT unless those assets have been settled into an excluded property trust prior to the individual becoming domiciled or deemed domiciled.

No IHT is charged on the transfer of foreign assets into the trust or at any later date in the life of the trust provided the trust is funded before the non-dom becomes deemed domiciled and the trust does not at any relevant time hold any UK assets directly. As a result of these rules, excluded property trusts tend to hold UK property through an offshore company. The shares in the non-UK holding company, and not the underlying UK property, constitute the settled property of the trust. Since there is no current provision to look through the company, the underlying UK property is effectively shielded from IHT.

However, per the proposal announced in the Summer Budget, the UK government intends to amend the rules on excluded property so that trusts or individuals owning UK residential property through an offshore company, partnership or other opaque vehicle will not be able to shield the UK residential property from IHT. The measure will apply to all UK residential property whether it is occupied or rented, and it is expected that this proposal will make direct ownership of residential real estate the most attractive form of ownership on a prospective basis.

Next Steps

Many questions remain open with respect to the changes to the RBC and the abolishment of the permanent non-dom status (for instance, how will split years of residence be counted?). For U.S. persons that have been long-term residents in the UK, it is hoped that the U.S. /UK tax treaty will address which convening country has the right of taxation for most major categories of income. However, the devil is always in the details. Her Majesty's Revenue and Customs is expected to issue a technical update in September 2015, which should start to address the details and mechanics of how this regime change will be implemented in the coming years.



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Now is the Time to Plan for Your 2015 and 2016 Transfer Pricing Positions



For many companies, the 2014 tax filing season has either come to an end or will shortly.

For those with global operations, now is an opportune time to revisit operational flows reflected in tax return(s) and consider whether any actions can and should be taken now to improve future tax results. For example, what is the company's effective tax rate (ETR) and how does it compare to its peer group? To the extent ETR may be perceived as high relative to peers, it may be worthwhile to assess whether your existing transfer pricing policy and structure can be modified to produce more tax effective and efficient operational flows.

Does your transfer pricing policy efficiently and effectively cover current operational flows?

From a compliance standpoint, several basic questions should be addressed including:

- Are there any de facto related-party transactions of material size not covered in either your existing transfer pricing policy or your contemporaneous transfer pricing documentation?
- Are there intercompany licenses in place that grant certain rights from your parent company (IP owner) to downstream operating affiliates and have the license fees been benchmarked for consistency with the arm's length standard?
- For related-party service transactions, were the cost bases accurately disclosed with reference to work papers? For example, were costs excluded for: (a) activities that did not provide a direct benefit? (b) activities of a stewardship nature? (c) pass-through expenses?
- Were appropriate mark-ups applied based on reference to comparable third-party benchmarks?
- Was a transfer pricing report prepared in certain jurisdictions that require formal contemporaneous documentation? In Canada, for example, taxpayers must disclose in their tax return whether they prepared contemporaneous transfer pricing documentation. In China, taxpayers must complete nine related-party transaction forms and, if certain volume thresholds are met, must also submit a formal transfer pricing report. Many other countries have similar requirements in place.

How will your transfer pricing position impact your tax provision?

Pursuant to ASC 740, publicly traded companies are required to identify and quantify their uncertain tax positions. Accordingly, because transfer pricing positions routinely end up being challenged in tax audits, taxpayers need to assess their processes for identifying, quantifying, and documenting not just the transfer pricing positions themselves, but also the tax provisions taken in regard to the transfer pricing positions. Any errors and/or lack of documented support could lead to a significant audit deficiency. Furthermore, such events will call into question a taxpayer's ability to satisfy its professional financial responsibilities through adequate internal control measures.

Can current operational flows be revisited in order to generate efficiencies?

In many cases, a company's operational flows evolve over time in response to changes in, among other things, market opportunities, locations of newly acquired companies, key customers, key suppliers, specific functional departments and/or executives. The key question that should be asked regularly is: does the company's current operational flows contain inefficiencies that should be streamlined. In addressing this question, a few basic areas should be considered, including:

- **Ownership of intangible assets:** In determining how operating profits should be allocated among entities within a controlled group, whether U.S. or foreign, place significant weight on which party(ies) own intangibles, particularly those connected to intellectual property (IP). In practice, examiners tend to connect IP ownership with the rights to accumulate residual profits after all other routine functions are compensated. Thus, the location of IP rights can have a significant impact on a company's ETR. It is important therefore to evaluate carefully the operational requirements of IP ownership and, where feasible, transfer IP rights to jurisdictions that offer both operational and tax efficiencies.
- **Product flows:** Taxpayers often assume that because the results of their related-party product transactions are consistent with those of unrelated third parties, such related-party transactions would also be considered at arm's length. However, that is not necessarily true because in many cases, the related-party transactions differ significantly from the unrelated third party transactions. For example, related party product transactions often operate according to a two-tiered structure in which a parent company sells product not just to related parties in foreign markets but also to a related party that acts as a regional super-distributor. In such case the regional super-distributor sells to unrelated third parties but also provides related parties in

other jurisdictions with regional support and oversight. If structured properly, the super distributor may be entitled to accumulate residual profits while capping the profits in the sub-licensing territories to a lower, routine level. Thus, while it may turn out that the super-distributor earns profits consistent with what unrelated parties earn, the super-distributor may in fact be entitled to higher profits because its functions are likely broader than those performed by the unrelated parties. Bottom line: transactions that appear to be arm's length may not be and further, there may be opportunities to improve tax efficiencies that aren't being pursued.

- **Service flows:** Many companies routinely streamline their support functions into shared services organizations, locating them according to where resource pools and/or lower wage levels reside. It is a best practice to locate service functions to jurisdictions offering a balanced mix of the desired resource pool, lower wages and favorable tax rates. Note that when high-value services are performed, it is important to ensure they receive arm's length compensation. Otherwise, tax authorities may assert that the local service affiliate has in fact created value intangibles/IP, which entitles it to accumulate (undesired) residual profits.

Plan now to get ahead

Before fiscal year 2015 winds down, taxpayers should evaluate the transfer pricing position implied by their operational flows and consider whether any steps should be taken to avoid unpleasant surprises. Whether that means accounting for transfer pricing adjustments to avoid an ASC 740 reserve, preparing (or updating) contemporaneous documentation or evaluating whether operational flows should be restructured, taxpayers would be well-served to apply a measure of prudence now while there is still time to properly align their fact profiles, transfer pricing policy and tax accounting.



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The Impact of a Buyer's Tax Perspective on S Corporation Valuations and Potential IRS Challenges



With the number of pass-through businesses growing 45% from 1986 to 2008, appraisals of S corporations has become one of the more highly discussed and debated topics in valuation.

Internal Revenue Service (IRS) Job Aid entitled *Valuation of Non-Controlling Interests in Business Entities Election to be Treated as S Corporations for Federal Tax Purposes* (Job Aid) presents IRS views of how to value subchapter S corporations. The Job Aid also presents challenges to valuation professionals when valuing pass-through entities. IRS concludes that *no entity level tax should be applied in the valuation analysis of a non-controlling interest in an electing S corporation, absent a compelling demonstration that independent third parties dealing at arms-length would do so as part of a purchase price negotiation*. An appraiser is therefore tasked with matching valuation approaches and the appropriate inputs with the economics of an interest in a subchapter S corporation paying particular attention to the pass-through attributes of the subject interest. Reconciliation of these disparate economics may be addressed with adjustments to the cost of capital/cash flows,

the inclusion of an S Corp premium and/or discounts related to control and marketability.

As most of the publically available information is based on C corporations, challenges arise when attempting to impute an S corporation value based on market data from C corporation. Since C corporations face two levels of tax as compared with the single level of taxation on an S corporation, with all else being equal, economically an interest in an S corporation is more valuable than that same interest in a C corporation. However, unlike a C corporation, an S corporation has several limitations including that it is a domestic entity, has 100 or fewer interest holders who are individuals, estates and certain trusts and certain pension plans and charitable organizations and has one class of stock. These factors imply that there can be additional risk in S corporations that may warrant increased minority and marketability discounts as compared to a C corporation.

Cost of capital inputs rely on market data from publically traded corporations. These rates of return are based on a C corporation tax structure. As a result, a mismatch may exist if S corporation cash flows are discounted with C corporation rates of return. Various S corporations models can address this issue by adjusting for the differences between C corporation returns and the cash flows available to a shareholder in an S corporation by calculating an S corporation premium to apply to after-tax cash flows. The Delaware Chancery Court in 2006 devised its own model assuming statutory tax rates for investors. Assuming the cost of capital was derived utilizing effective tax rates for the public companies, an appraiser may adjust the tax rate on corporate income in the S Corporation Economic Adjustment Model (SEAM) to reflect the fact that investors seek to minimize taxes. The use of this model is a common approach in S corporation valuations today. While the Job Aid takes issue with S corporation premium being derived from models utilizing theoretical assumptions that have been untested in the market, it does reference a theoretical model, validated by market data, by Merle M. Erickson and Shiing-wu Wang, which found that a controlling interest in an S corporation has a premium in the range of 10-20% over a similar interest in a C corporation. This range of premium is consistent with the typical range determined when using the SEAM.

There are several factors that could impact the adjustment to the cost of capital (the S corporation premium as discussed above) or affect discounts related to marketability or control. Given the parameters of an S corporation, the universe of potential buyers may be limited and the ability to raise capital could be impeded. The valuation specialist must address questions related to the interests of the hypothetical buyer and the hypothetical seller as well as assessing how the hypothetical sale would occur. The overall attractiveness of the subject interest from the perspective of a hypothetical, likely buyer can be affected based on the existing and prospective direction of the company with respect to the policies in the shareholder agreements for items such as distributions, transfers or rights of first refusal. All of these factors should be considered when determining if adjustments should be made to the cost of capital and if any discounts are applicable.

In addition, when valuing an S corporation the appraiser needs to consider whether a likely buyer would be a C corporation, which would be taxed at the entity level. The facts and circumstances of the subject interest may determine that a C corporation or other non-qualified buyer could be the highest bidder. The Job Aid acknowledges that although it is believed it to be unusual, a non-qualified buyer may purchase a minority interest in an S corporation in circumstances such as a creeping acquisition by a strategic buyer. This is an area in which the valuation specialist must exercise particular caution and look to Tax Court rulings for precedent.

Despite academic evidence to the contrary, the Job Aid seeks to disallow most after-tax analysis in the valuation of S

corporations. However, a careful reading of the Job Aid and a clear understanding of the facts and circumstances still permit the recognition of a buyer's tax perspective when performing an S corporation valuation. That said, it is critical that appraisers understand how the after-tax models take into account factors such as cost of capital and S corporation premium and how their results could be challenged by IRS.



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