



## Tax Planning Opportunities During a Market Decline



*Investors in the global marketplace likely experienced declines in their portfolios at the close of 2015 and early during 2016.*

While understandably making investors nervous, a downturn in the economy may pose considerable tax planning opportunities, for both income and transfer tax purposes. The following are just some of the strategies that can take advantage of a down market.

### Convert a Traditional IRA to a Roth IRA

Taxpayers that have a traditional individual retirement account (IRA) may find that a bear market is the best time to convert those tax deferred assets to a designated Roth IRA. The advantages of the Roth IRA over a traditional IRA are that qualified distributions from the Roth are tax-free, there are no minimum required distribution

requirements and if the account holder dies before exhausting the account distributions to beneficiaries remain income tax free.

At conversion, the taxpayer will pay ordinary income tax on the market value of those converted assets. However, depressed market values of the assets held in a traditional IRA will yield a lower tax bill than if the same conversion were to occur for the same assets during an up market. The resulting benefit is that the taxpayer has minimized the tax liability thanks to lower market values while also moving the assets into a tax advantaged account where they will hopefully appreciate in the future.

## Exercise Nonqualified Stock Options

Many employers offer key employees stock options as an additional benefit to their regular compensation. One of the most common form of options granted are nonqualified stock options (NSOs). A NSO is an option to buy company stock at a price less than its fair market value when the option is exercised. The spread between that purchase price and fair market value is included in taxable income in the year the option is exercised and reported via the employee's W-2. If the stock is currently at a low valuation due to poor market conditions but the employee expects the value to appreciate in the long-term, it may be worth considering exercising those options now. The result would be a smaller current income tax bill with the expectation of future growth and capital gains treatments if the stock is then sold.

Consider the following example where a taxpayer holds a NSO to buy company stock for \$20 per share with an expectation to exercise the option and hold the stock until its fair market value reaches \$40 per share, at which point the taxpayer will sell the stock. If the taxpayer exercises the option after a market decrease when its fair market value is down to \$25, the taxpayer will report \$5 per share of current ordinary income. If the taxpayer holds the stock for a long-term period and sells at \$40 per share, the \$15 per share gain will be taxed at favorable long-term capital gain rates. If the taxpayer had waiting until the price recovered to say, \$35 per share before exercising the option, then \$15 per share would be taxed as ordinary income currently and only \$5 would receive favorable capital gains tax rates.

## Gift Assets at a Reduced Transfer Tax Cost

The general rule is it's better to gift an asset at a lower value than a higher value. With the value of the gifted asset being lower than it would in an up market, a transfer tax opportunity exists to move more wealth out of a high-net-worth individual's estate at a lower transfer tax cost. This could mean moving more shares of a stock with promising long-term appreciation prospects while not exceeding the annual exclusion limit. It could also mean having to utilize less of a taxpayer's unified estate and gift tax credit than in stronger economic environment as well. This simple but effective transaction can yield significant long-term tax benefits, particularly if done in the multi-generational context.

It should however be noted that it is generally not advisable to gift an asset outright if its basis is higher than its fair market value as that potential loss cannot transfer to the donee. In such a circumstance, the donor should either gift a different asset, or sell that asset, recognize the loss, and then gift the cash. The donee can then repurchase that asset.

One way taxpayers can leverage this concept, particularly if they have used all their gift tax exemption, is through the use of a Grantor Retained Annuity Trust (GRAT). A GRAT can take advantage of the current economic environment by combining the benefits of a low Sec. 7520 interest rate and the potential for future appreciation of

assets.

In this transaction, an asset is transferred irrevocably into a trust which will pay an annuity to the grantor for a term of years. Because the present interest value of the annuity is equal to 100% of the asset value plus that Sec. 7520 rate, there is little to no gift tax ramifications on the transfer. If the asset appreciates at a rate exceeding the Sec. 7520 rate (1.8% in June) and the grantor outlives the trust term, that appreciation is successfully transferred at little to no gift tax cost. Since the annuity payments are based on the asset value as of the transfer, depressed market values can make it more likely for the GRAT to be successful.

While most investors would agree that a market downturn that would not be classified as a positive event, such a downturn is not without its opportunities. Depressed values can allow for potentially significant income and transfer tax savings and taxpayers should look to take advantage of these opportunities.

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## Can the Endowment Model of Investing Be Applied to Individuals?



*While there are numerous differences between individuals and institutional endowments which impact their ability to utilize this model to its fullest, the basic tenets of the endowment investment model can still be applied to an individual's portfolio.*

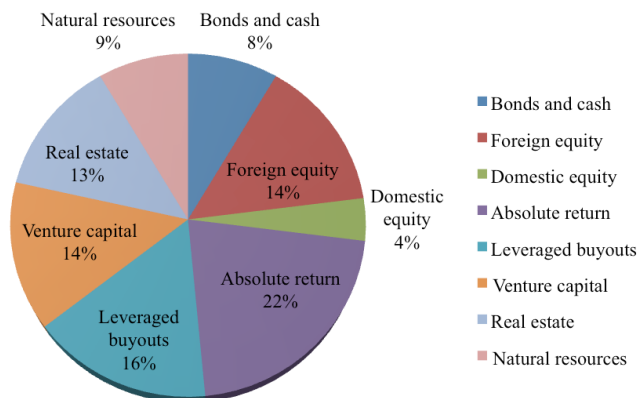
### The Origins of Modern Portfolio Theory and Endowment Model

Harry Markowitz first detailed Modern Portfolio Theory in the *Journal of Finance* in 1952. In his paper Portfolio Selection, he presented evidence illustrating an efficient frontier of optimal portfolios that maximize expected returns for a given amount of risk. Up until this point, investment returns were considered to be driven by security selection. However, Markowitz found that looking at the risk and return characteristics of each security individually was not sufficient. Alternatively, by diversifying across a set of asset classes, with different risk/return characteristics and low correlation to one another, an investor can achieve a higher risk-adjusted return.



In the 1990's, David Swenson, the Chief Investment Officer for Yale, used Modern Portfolio Theory as a basis for what came to be known as the endowment model. He maintained the importance of diversification across asset classes and Yale placed a heavy emphasis on investing in alternative strategies, such as hedge funds, private equity, and real assets (i.e., natural resources, real estate). As can be seen from Yale's 2016 target allocation below, nearly 75% of the assets are allocated to alternative investments:

### Yale's 2016 Target Allocation



Source: Yale Daily News

### Have Alternative Strategies Historically Generated Outsized Returns?

According to Cambridge Associates, U.S. Private Equity generated an annualized return of 13.5% and U.S. Venture Capital generated an annualized return of 30% for the 20-year period ending September 30, 2013. For the same period, the S&P 500 annualized return was 8.8%.

So how have these strategies generated these types of returns? Generally speaking, the more information an investor has, the more likely they are to earn a higher risk-adjusted return. Because there is generally less widespread information relating to alternative investment strategies (i.e. there is a greater abundance of information with respect to blue chip stocks than there are alternative investments), those who have that information are at an advantage. Additionally, investors are rewarded with an illiquidity premium for committing capital for long periods of time, which is typically the case with alternative investments. To tie this back to the principles of Modern Portfolio Theory, the greater risk one takes on (in this case, locking up your capital), the greater reward one should expect.

### Why Don't Individuals Adopt the Same Strategy as These Esteemed Institutions?

Despite the largely positive institutional track record, there are key differences between individuals and institutions that can prevent an individual or wealthy family from truly maximizing the benefits of the endowment model.

First, an institution is theoretically expected to exist in perpetuity and therefore may have an extremely long time horizon for its investments. They are better able to hold onto illiquid investments as they typically do not need to fund shorter-term liabilities. Individuals typically have to plan for nearer-term cash flows such as retirement expenses and are reliant on their portfolio for liquidity. More often than not, managers impose gates which limit when investors can access their money. Alternative investment managers benefit from these gates, as they are not under pressure to sell a position at an inopportune time to meet liquidity requests.

Second, institutions with endowments are usually tax-exempt organizations, not subject to the same taxes as

individuals. Taxes erode the returns of an individual's portfolio and, over the course of time the compounding effect can be very detrimental. Endowments are able to invest without consideration of tax implications, a luxury individuals do not have.

A third difference is that access to sophisticated alternative investment strategies and information relating to them is limited. These strategies often have strict investment terms and extremely high minimums that only the largest institutions are able to meet. Additionally, many of the most coveted strategies are closed to new investors.

With the advent of liquid alternatives with lower investment minimums, more individual investors are able to gain some exposure to alternative asset classes through mutual funds, exchange-traded funds and closed-end funds. These investments do not have lock-up periods or gates, so investors are able to access money monthly or even daily. The benefit of liquidity, however, means the investor is subject to the whim of other investors, which can result in negative implications to investment returns and tax consequences. Studies have shown that return expectations should be reduced when using liquid alternatives.

Last but certainly not least, the Achilles heel of individual investors is emotion, and institutions lack the emotional exuberance and exasperation inherent in most individual investors. Individual investors often make shortsighted decisions regarding their portfolios based on fear or greed. Institutions, however, tend to adhere to their long-term time horizons for the investments, and are not as hasty to make abrupt changes to their portfolio during extreme market volatility.

## Integration of the Endowment Model for the Individual

While there are clear barriers that prevent individuals from replicating the endowment model for their own portfolios, the pillars of the endowment model, as outlined below, can be broadly applied to individuals when constructing investment portfolios:

- Broadly diversify the portfolio across asset classes.
- Allocate a portion of your portfolio to alternative strategies with lower correlation to more traditional, long-only strategies.
- Maintain a long-term perspective on the portfolio and be prepared to participate in full market cycles.
- Ensure you have accounted for liquidity needs so you are not forced into exiting illiquid investments prematurely.

While the endowment model is certainly tailored more to institutions, it is important that individuals do not dismiss the model entirely, as they can still benefit from applying its core principles.

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## New GAAP Revenue Recognition Rules: Is Your Tax Department Ready?



*The FASB's new revenue recognition rules are required to be implemented for years beginning after December 15, 2017 for public companies and after December 15, 2018 for private companies.*

The new rules are fundamentally different than current revenue recognition standards, which until now have been more aligned with tax revenue recognition principles. The new rules may result in significant differences in the amount of revenue recognized from one period to the next for some companies. However, even if the difference is small, accounting processes and financial reporting will change. This presents a challenge for the tax executive who relies on financial statement reports for tax reporting.

### New Five-Step Recognition Model



In May 2014, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) jointly issued the new revenue recognition standard ASU No. 2014-09, *Revenue From Contracts With Customers (Topic 606)*. The new standard supersedes nearly all existing revenue recognition guidance under U.S. GAAP and International Financial Reporting Standards.

With some exceptions, the new revenue recognition standard applies to all contracts with customers. Under the new standard, revenue related to the transfer of promised goods and services to customers is recognized in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods and services. The new standard provides the following five-step model for determining the timing and amount of revenue recognized for contracts:

1. Identify the contracts with a customer;
2. Identify the performance obligations in the contract;
3. Determine the transaction price;
4. Allocate the transaction price to the performance obligations in the contract; and
5. Recognize revenue when (or as) the business satisfies a performance obligation.

The new standard is to be implemented with either a full retrospective approach for all periods presented in the period of adoption (generally three years) or a modified retrospective approach with the cumulative effect adjustment to retained earnings as of the date of adoption.

## Practical Implications of the New Standard

Existing contracts must be analyzed and the accounting processes may need to be revised. Companies will need to exercise more judgment and make more estimates as compared with prior guidance where income was generally recognized based on the terms under the contract. Management judgments and estimates may also require periodic updating. In addition, business processes and IT systems may need to be developed or updated to capture and monitor management's judgments and subsequent changes.

Very importantly, changes in the timing and amounts of revenue and expenses recognized for financial reporting purposes may prompt changes in tax accounting methods and processes. The tax department and outside tax advisors should be involved in the early stages of making the assessment.

## Tax Implications of the New Standard

A company using an accrual method of accounting recognizes revenue for tax purposes when the right to receive the revenue is fixed and the amount can be determined with reasonable accuracy. For sale of goods, revenue is earned when the benefits and burdens of ownership pass to the customer. For services, revenue is recognized when the performance of services is complete.

When a taxpayer changes a method for financial accounting purposes it must either request permission from IRS to change to the new method for tax purposes, or reconcile from the new financial accounting treatment to the old tax accounting method that is continued. IRS generally treats a change for financial reporting purposes as a method change for tax purposes. If a new tax accounting method is required or more advantageous as a result of the book treatment under the new standard, Form 3115, *Application for Change in Accounting Method*, should be filed with IRS. The filing procedures and timing vary based on whether the change can be filed under the automatic consent

procedures or whether advance consent from IRS is required.

Under the new standard, a company may be required to recognize revenue for financial reporting purposes under a method that is not a proper method for tax purposes. For example, the transaction price of a contract is not required to be fixed or determinable to recognize revenue under the new standard. This change may result in timing differences between book and tax because revenue may be recognized for book purposes before it is fixed, determinable and recognized for tax purposes. When this occurs, dual records will need to be maintained to support the tax methodology.

The new revenue recognition standard will also have implications for the accounting for income taxes. The cumulative adjustment required upon adopting the new standard may result in changes to deferred tax assets and liabilities. New temporary differences may arise. For some companies, changes in taxable temporary differences arising from the application of the new standard may also have effects on the evaluation of a valuation allowance. Businesses should expect new complexities in the transition period as well as on an on-going basis.

Additional guidance from IRS will be necessary to address inconsistencies between the new standard and the tax rules, and to streamline the process of implementing changes from a tax perspective. The Treasury Department and IRS have requested public comments on these issues, but no guidance has been issued thus far. Tax executives should begin to prepare for these upcoming changes as soon as possible.

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## Tax Opportunities Related to Personal Goodwill



*Sales transactions involving closely held businesses can be complex, and there are potential benefits to both buyers and sellers depending on how such transactions are structured.*

This article explores the concept of personal goodwill in sales transactions and how proper structuring can result in favorable tax treatment.

Personal goodwill exists when a shareholder's reputation, expertise, or relationships contribute significantly to a company's value and future income stream. Personal goodwill usually manifests itself in the form of close relationships with customers and/or suppliers. These established relationships are often critical to a business' success and therefore should be considered if an entity is sold.

When a business is acquired in a transaction that is structured as an asset purchase for tax purposes, the buyer and

seller are required to allocate the purchase price to the tangible and intangible assets acquired. If a portion of the purchase price can be allocated to personal goodwill of the selling shareholder, the buyer will benefit from future amortization of that goodwill. From the seller's point of view, the more sales proceeds that can be allocated to personal goodwill and taxed to the individual shareholder, the less will be subject to the less-favorable corporate tax rules (i.e., income that is taxable first to the corporation and then to the shareholder(s)).

Because of this tax treatment, IRS has a history of challenging the allocation of purchase price to personal goodwill. As a result, the parties should have prepared a well-reasoned valuation by an experienced third-party appraiser to document their assumptions and conclusions, and ultimately support the allocations.

## Demonstrate that Personal Goodwill Exists Separate from Corporate Goodwill

Establishing personal goodwill exists separate from corporate goodwill is the first step in this type of analysis. The existence of personal goodwill can be substantiated by certain facts such as client relationships, relevant credentials of the key individual, or reputation, among other factors. A taxpayer must prove that the value is dependent on the key individual, as opposed to the company's intangibles and operations. As a result, personal goodwill often arises in professional practices or closely held businesses where the efforts of a single individual may have more of an impact.

The *Martin Ice Cream* case is one of the seminal cases in the area of personal goodwill. Arnold Martin, a shareholder of Martin Ice Cream Company (MIC), exchanged his stock in the company for ownership in a subsidiary called Strassberg Ice Cream Company (Strassberg), which was MIC's supermarket distribution business. Shortly thereafter, Pillsbury Co. purchased certain assets of Strassberg and paid Mr. Martin \$1.2 million for *seller's rights*. IRS contended that all of the assets purchased were corporate assets. The Tax Court found, however, that the assets were, in fact, personal because the success of Strassberg's business was contingent on the personal relationships of Mr. Martin. Also of importance was that during his tenure at Martin Ice Cream, Mr. Martin never had an employee contract or non-compete agreement.

## Separate Personal Goodwill from Business Assets

Once the existence of personal goodwill is established, the taxpayer must personally hold the right to sell goodwill. The taxpayer cannot have previously transferred the goodwill-related assets to the company. Once a shareholder transfers his personal goodwill through an employee contract or non-compete agreement, the existing goodwill then belongs to the corporation. If preexisting contracts exist between the taxpayer and company before the transaction, then the existence of personal goodwill is voided.

In the case of *Howard v. U.S.*, a practicing dentist incorporated his sole proprietorship and entered into an employment contract and non-competition agreement with his business. Later, Mr. Howard sold his practice. He allocated a significant portion of the sale price to personal goodwill. IRS argued that the employment agreement made the personal goodwill an asset of the company and, as a result, proceeds made to Mr. Howard for personal goodwill reflected a dividend payment from the corporation. The Court of Appeals for the 9th Circuit upheld IRS's re-characterization of the sale payment and noted that while personal goodwill had existed in the form of personal relationships, the goodwill no longer belonged to Mr. Howard when he conveyed control to his business.

## Structure the Transaction Appropriately

Even in cases where personal goodwill was present, the Tax Court has ruled against taxpayers due to a lack of

supporting contractual documentation or an appraisal. It is important that the personal goodwill be clearly identifiable in the purchase agreements so that the intention of the parties is known.

Likewise, in the case of *James P. Kennedy*, the Court found that even though personal goodwill existed, it was not enough to conclude that the goodwill was sold. In many cases, the contractual allocation of a payment to goodwill is critical in determining whether the payment was, in fact, for goodwill. Observing formalities and maintaining extensive documentation will bolster the credibility of this allocation.

## Consider Hiring an Experienced Appraiser

Because IRS has had success in challenging poor or inconsistent fact patterns, having a third-party appraisal can help the taxpayer withstand scrutiny and substantiate a claim of personal goodwill. When executed correctly, appraisals can play a critical role in securing this advantageous tax outcome for both the buyer and seller.

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