NEWS YOU CAN USE FROM WTAS

for the RECORD

May 2012

IN THIS ISSUE

FBAR vs. Tax FBAR – What's the Difference?

The Hiring Incentives to Restore Employment (HIRE) Act in 2010 includes the Foreign Account Tax Compliance Act (FACTA), which requires certain individual taxpayers to file Form 8938, Statement of Foreign Financial Assets, commonly referred to as Tax FBAR.

This new reporting requirement is in addition to filing Treasury Department Form 90-22.1 (Report of Foreign Bank and Financial Accounts), more commonly known as FBAR. Although these two acronyms look similar, there are some very significant differences.

FBAR

The FBAR is not a tax filing requirement. It is part of a set of laws called the Bank Secrecy Act. Although the forms are filed with Internal Revenue Service (IRS), the rules governing the reporting requirements are not tax based. Examination and enforcement authority related to FBAR filings has been delegated to IRS. A primary purpose of the FBAR filing is to track hidden money in foreign financial accounts used for illicit purposes (e.g., tax evasion, money laundering or terrorism).

Tax FBAR

The primary purpose of Tax FBAR is to enforce higher tax compliance among United States taxpayers with specified foreign financial assets (SFFA). This filing requirement does not replace or otherwise affect a

CONTRIBUTORS

Rick Ackel
Jacqueline Annino
Jared Banner
Andrew Bernard
Marilyn Calister
Matthew Dianich
Sallie Faucett
Raymond Freda
Emily Hall
David Perez
David Roberts
Martin Skrip
Kenneth Zemksy

taxpayer's requirement to file FBAR; this is a tax form that needs to be filed in addition to TD F 90-22.1.

FBAR vs. Tax FBAR

There are several notable differences between the FBAR and Tax FBAR filings. A few of the more basic differences are described below; however, many others exist in the details of the filing instructions and regulations, and taxpayers should carefully follow the guidance and exceptions for both filings.

Who does each filing pertain to?

- FBAR pertains to individuals and domestic entities that have a financial interest in foreign financial accounts. It also pertains to individuals that have signatory authority over foreign financial accounts (e.g., bank, brokerage, investment accounts, etc.). Currently, Tax FBAR is only required to be filed by certain U.S. specified individuals for 2011; domestic entities are not required to file. IRS, however, anticipates issuing regulations that will require certain domestic entities to file in future years. Tax FBAR reports the ownership (not signatory authority) of SFFAs (e.g., certain financial accounts, certain interests in foreign entities, and certain financial instruments or contracts with a non-U.S. counterparty) as well as the tax item (e.g., interest, dividends, royalties, etc.) attributable to those SFFAs.

What are the thresholds for filing?

- In general, a U.S. person (individual or domestic entity) must make a FBAR filing if the aggregate value of the foreign financial accounts exceed $10,000 at any time during the calendar year. Varying thresholds apply to Tax FBAR filings, dependent on the marital status and country of residence of the specified individual. Unmarried specified individuals living in the United States must file if the total value of the SFFAs are more than $50,000 on the last day of the tax year or more than $75,000 at any time during the tax year. These thresholds increase to $100,000 and $150,000, respectively, for married specified individuals living in the United States. Unmarried specified individuals living abroad must file if the total value of the SFFAs is more than $200,000 on the last day of the tax year or more than $300,000 at any time during the tax year. These thresholds increase to $400,000 and $600,000, respectively, for married specified individuals living abroad. Specified individuals living outside the United States must satisfy certain presence abroad tests in order for these increased thresholds to apply.

What are the penalties for non-compliance?

- Currently, both FBAR and Tax FBAR carry monetary penalties for failure to file. These monetary penalties start at $10,000 for each non-willful violation where the reasonable cause exception does not apply. Willful FBAR violations can increase the penalty to the greater of $100,000 or 50% of the amount in the foreign financial account for each violation. The additional maximum Tax FBAR failure to file penalty is $50,000. Tax FBAR filings also carry accuracy-related penalties up to 40% of the underpayment related to the undisclosed SFFA. For example, this penalty might be assessed against an individual taxpayer who received a taxable distribution from a foreign pension that was not reported on Form 8938 and Form 1040.
- Non-filings of FBARs and Tax FBARs can result in other negative consequences. In certain instances, willful FBAR violations can carry both civil and criminal non-monetary penalties. Since Tax FBAR is a tax filing, IRS has the ability to keep the statute of limitations open on all or part of the associated annual income tax return until three years after the date on which the Tax FBAR form is filed.

What are the due dates and filing methods?

- Another important difference between the two filings relates to the due date and method of filing for each form. As was mentioned previously, FBAR is not a tax form; therefore the filing deadline of June 30th does not coincide with other tax filing deadlines. In addition, the "mailbox rule" does not apply; the form must be received by IRS by the filing deadline. Tax FBAR filings must be attached to and filed with the taxpayer's annual income tax return by the due date of that return. Accordingly, the mailbox rule applies to Tax FBAR filings similar to the applicability of this rule to the annual income tax return—timely mailed is timely filed.

Although the acronyms are similar, the FBAR and Tax FBAR filings have significant differences in both purpose and reporting. The Justice Department and IRS have ongoing efforts to pursue and prosecute those that are negligent in filing the proper FBAR forms. IRS recently reopened the Offshore Voluntary Disclosure Program to encourage those with delinquent filings to get current. The addition of Tax FBAR creates additional filing responsibilities for individual taxpayers with SFFAs and it appears it will create an additional filing burden for certain domestic entities in the near future. ■

I Got a Notice CP from IRS - What Does This Mean?

The financial press is abuzz with all the latest announcements from IRS about calls for increased enforcement of the nation's tax laws.

IRS recently announced they have reviewed or audited nearly a third of all tax returns that reported income of $10 million or more in the past year. One may recall in the September 2010 issue of *For the Record*, IRS introduced the Global High Wealth Industry Group in 2009 - a specialized team within IRS to pursue a more unified approach to audits of wealthy individuals. With that context in mind, this is a good time to review the most common types of letters and notices that IRS sends taxpayers.

It is important to note that very few audits actually require a face-to-face meeting with an IRS agent. There are many issues that IRS can examine or question on a taxpayer's return via correspondence. Often, having a good understanding of what positions in a return are being examined as well as responding in a timely fashion to IRS inquiries can result in a quick resolution of the audit or examination.

Here's a brief overview of the more common types of notices:

- Notice CP 30 *Estimated Tax Penalty*: This form is used to notify a taxpayer all or part of an overpayment has been applied to an estimated tax payment penalty. It will also advise a taxpayer that all or some of required estimated tax payments were not timely. It is important to double check your records to determine whether the payments were made on time. It is recommended that payments be made through the electronic deposit program, or alternatively, mailed in via certified mail.

IRS recently announced they have reviewed or audited nearly a third of all tax returns that reported income of $10 million or more in the past year.

- Notice CP 2000 *Notice of Proposed Adjustment for Underpayment/Overpayment (aka the Matching Notice)*: Receipt of this notice is fairly common and is mainly due to the increased Form 1099 e-filing requirements for financial institutions. The notice will typically list out proposed adjustments to a tax return and indicate the total increase in tax based on the changes. Although it may look like a demand for payment, it is not really a final determination

of changes to a tax return. IRS uses this notice to request additional documentation from the taxpayer to verify the income, credits and deductions reported on your tax return because they're different from the information received from other sources. This letter often includes a detailed description of the adjustments and the basis for IRS position, which is presented in an Explanation of Items (Form 886-A). A typical Form 886-A will contain the issue, the facts, the IRS legal position and the IRS understanding of the taxpayer's position. Good recordkeeping is of the utmost importance when preparing a response to this type of notice. If the taxpayer can substantiate the rationale for the position taken, as well as provide adequate third-party documentation for the amounts in question, the taxpayer has a greater likelihood of obtaining a speedy and favorable resolution.

- Letter 525 *General 30 Day Letter:* Per IRS: "This letter accompanies a report giving you a computation of the proposed adjustments to your tax return. It informs you of the courses of action to take if you do not agree with the proposed adjustments." Basically, the letter outlines what to do if a taxpayer wants to appeal the findings within IRS. The taxpayer should submit a request for appeal/protest to the office/individual that sent the letter. The protest should be filed within 30 days from the date of the letter in order to appeal the proposed adjustments with the Office of Appeals.
- Letter 531 *Notice of Deficiency*: This is the letter advising a taxpayer of their last chance to appeal. Per IRS: "The Internal Revenue Code authorizes the Commissioner to send this notice. The letter explains how to dispute the adjustments in the notice of deficiency if you do not agree. To dispute the adjustments without payment, you file a petition with the Tax Court within 90 days from the notice date." If a taxpayer neglects to address this letter, the collection process can officially begin.
- CP 504 *IRS Intent to Levy*: This is a final notice of a balance that is due on the taxpayer's account. This is usually the fourth notice that is sent, and will inform the taxpayer that a levy will be issued against their state tax refund. It may also include details stating that IRS plans to search for other assets on which a levy can be placed. Additionally, a Federal Tax Lien may also be filed if payment is not made at once.

This article can only provide a sample of the more common types of IRS notices. It cannot be overemphasized that responding timely to IRS is critically important. IRS has many tools at their disposal that can quickly escalate the severity of the penalties that can be imposed for willful neglect or noncompliance. However, it is important to note that many IRS notices, especially matching and late payment notices, are erroneous or have a simple explanation. ■

New York Combined Reporting: A Need for More Clarity

Five years into the revised New York combined reporting system there is still little guidance and many questions remain, even after answers in the April, 2007 law change.

By way of background, the law change was enacted in April; however, it took effect for years beginning on and after January 1, 2007. The bill signed by then-Governor Spitzer overhauled New York's combined filing law.

Prior to the change, the law basically left the matter to regulations, which were promulgated by the Tax Department. The regulations contained three requirements for combined reporting:

- an 80% ownership test, similar to that embodied under the federal consolidated return rules;
- a requirement that the affiliates be engaged in a "unitary" business, broadly defined as engaged in the same or related trades or businesses; and
- a distortion requirement.

The latter was further defined as presumed to exist where at least 50% of a company's receipts or expenses derived from substantial inter-corporate transactions or where distortion could otherwise be demonstrated (sometimes referred to by practitioners as "soft distortion" as opposed to that shown by the inter-company transactions test). Thus stripped to its core, distortion could be proven by demonstrating distortion. With such vagueness and subjectivity built into the regulations, an abundance of litigation resulted. The bulk of the cases dealt with taxpayers who were trying to resist forced combination and did so by trying to show that the inter-company pricing among the affiliates was at arm's length, hence no distortion existed, despite the large amount of inter-company sales.

When the law change was proposed, the Governor stated that the intention was to reduce the drain on the Tax Department's resources in having to deal with all of the litigation, and that the amendment made only one change - it removed the presumption of distortion. That is, the matter became one of law and not of regulation and the 50% test was embodied in the statute. Moreover, the 50% test could not be rebutted by any other showing of distortion, whether by reference to arm's length pricing standards or by any other means.

The major issue to date centers around the guidance, or more appropriately the lack thereof, for the revised sections of the law. The old regulations, which obviously have been largely superseded, have yet to be withdrawn. A new iteration of the

regulations were proposed in the winter of 2008, but they were retracted and nothing has been issued to date, despite the passage of five years.[1] To date, there have been no published cases to give guidance to the application of the new law, likely because the 2007 and succeeding audit periods are just now coming under audit scrutiny. The Tax Department did issue a ruling, which it subsequently revised, that does not meaningfully clarify matters. The ruling, known as the TSBM (taxpayer services bureau memorandum) adds a few new wrinkles not contained in the law. One is a misleading and cumbersome ten step analysis. Note, the ten steps derive from the number of affiliates in the hypothetical set forth in the ruling. In reality, a combined reporting analysis can be as little as two steps or hundreds, depending on the number of subsidiaries to which the analysis need be applied. A second wrinkle is that, in addition to the substantial inter-company transactions test set forth in the statute (and in the predecessor regulation), the TSBM established a second test dealing with asset transfers (a 20% test).

Consider some of the issues that have resulted:

1. Whereas the old regulations contained a unitary component as part of its three-tier test, the new law is silent. Importantly, the TSBM sets forth a unitary requirement as part of its asset transfer test but not as part of its inter-company transactions test. By implication that would suggest that a unitary relationship is not required for the 50% test, though such a suggestion is at odds with well settled Supreme Court precedent, which has long held that a unitary relationship is the linchpin for combined filing.
2. In applying the 50% test, the TSBM states this is done on a one-to-one basis. That is, if Company A receives all of its income ratably from each of four subsidiaries, then the test is not met, since at least 50% did not derive from any one affiliate. This seems at odds with the actual reading of the revised law.
3. The TSBM states that the Tax Department can consider, despite the result of the substantial inter-company transactions test, whether there is some overriding tax motivation that compels a combined reporting conclusion apart from that resulting from pure application of the transactions test. Doesn't this simply restore the old soft distortion test, which the statute supposedly abolished? Moreover, if the Tax Department can apply soft distortion, can taxpayers and tax practitioners be barred from doing likewise? Keep in mind, there is case law dealing with the old 30-day rule (i.e., once upon a time taxpayers had to request combined filing within 30 days of the close of the taxable year but the department had up to the three-year statute of limitations to act on combination). Since this created an unconstitutional disparity between both sides, the 30-day rule was abolished. In other words, the rules must apply equally to taxpayer and tax administrator alike. If there must be symmetry in the application of the law then has soft distortion been unwittingly restored?

These are just a few of the questions that have arisen. There is clearly much complexity and need of tax expertise in this area, especially since it remains a fertile area of audit by the Tax Department. ■

1 Officials at the Department of Taxation and Finance have confirmed that they expect to propose new combined regulations for promulgation before the summer.

10 Year Period to Change Election to Deduct Rather Than Credit Foreign Taxes May Not Apply

Background

In lieu of the three-year period that normally applies to filing amended tax returns to claim a tax refund, taxpayers have generally had 10 years to decide whether to claim a deduction or credit for foreign taxes paid (or deemed paid). Since taxpayers may carryover unused foreign tax credits (FTCs) for 10 years, it seems logical to allow taxpayers 10 years (rather than three) to determine whether to deduct or credit these taxes. In fact, it is not unusual for taxpayers to amend their returns to switch between deducting or crediting foreign taxes because of unforeseen events that made one choice more beneficial than the other.

However, in a recent Chief Counsel Advice (CCA), Internal Revenue Service rejected as untimely a refund claim by a U.S. consolidated group resulting from an election to deduct rather than credit foreign taxes paid in a prior tax year. The refund claim was filed beyond the normal three-year statute of limitations (SOL) period but still within 10 years of the original filing date.

Salient Points of Chief Counsel Advice 201204008

The CCA stated that the 10-year SOL only applies if the claim for refund or credit relates to an overpayment attributable to any taxes paid or accrued for which credit is allowed against U.S. income tax. Under the facts of the CCA, the taxpayer had claimed a credit for its foreign taxes paid. However, as it turned out, claiming a credit for such taxes resulted in no benefit in the year the credit was claimed or in the credit carry-forward period. On the other hand, deducting the foreign tax created a loss that could be carried back to a prior year. This carryback would result in a refund of U.S. taxes previously paid. The CCA concluded that such a refund claim did not fall within the 10-year SOL that normally applies to refunds based on a foreign tax credit claim.

The CCA provided the following rationale: the 10-year SOL statute uses the word "allowed" rather than "allowable." Based on this distinction, the CCA concluded that the 10-year SOL applies only where the taxpayer claims a credit rather than a deduction. This is because the statutory language governing the 10-year SOL states that it applies only where the claim for refund is based on foreign taxes "for which credit is allowed." Thus, in order to apply the 10-year SOL, the refund must stem from an attempt to credit, not deduct, foreign taxes.

Another way to read the statutory language would be to allow the extended SOL for claims based on foreign taxes of a type for which credit is allowed. Under this reading, the 10-year statute would apply if the underlying foreign tax is of a type "for which credit is [normally] allowed." That reading might have prevailed if the statute had used the word "allowable" in lieu of "allowed." However, it does not and because of this, IRS presumably concluded it was precluded from applying this interpretation even though such a reading would be consistent with the policy of allowing taxpayers more time to resolve matters involving foreign income taxes.

Observations

While the CCA is not binding authority, it may indicate how IRS will approach this issue in future cases. Thus, taxpayers should not be surprised if IRS denies a refund request based on a new decision to deduct, instead of credit, foreign taxes if the change is made after the normal three-year SOL expires but within the 10-year SOL. Taxpayers may find that they will have to undertake additional measures in order to obtain a refund, like taking the matter to appeals and/or considering litigation.

Taxpayers in an excess credit position who are concerned that the logic outlined in this CCA may apply to them have at least two options. One is for taxpayers to consider developing arguments to fortify their position that the extended SOL applies to a claim based on a deduction. In other words, taxpayers should develop a position based on legislative intent, court cases or other authority that the word "allowed" in the statute does not limit application of the extended SOL to credit claims, and then be prepared to fight IRS at appeals or in court. In the second option taxpayers may adopt a policy of claiming a deduction in lieu of a credit in the first instance and then reverse that decision prior to the expiration of the 10-year SOL. Presumably filing amended returns based on a decision to claim a credit in lieu of a previously claimed deduction would be allowed even under the logic of the CCA. In any event, it is clear that taxpayers should consider the impact of the CCA on their positions and develop a plan either to fall within or to refute its logic. ■

The Peco Case: Are You Giving Enough Attention to Details in Purchase Price Allocations?

A recent Tax Court decision emphasizes the importance of planning and proper attention to detail when drafting purchase price agreements, and commissioning cost segregation studies.

Earlier this year, the Tax Court determined that a taxpayer, Peco Foods, Inc. and Subsidiaries (Peco) could not modify agreed-upon purchase price allocations by subsequently reallocating and subdividing acquired assets into various subcomponents for tax depreciation purposes.

Background

Peco acquired two poultry processing plants in the mid-1990s through two separate asset acquisitions. Both purchase agreements noted the stated allocation of the purchase price among the acquired assets would be "for all purposes (including financial accounting and tax purposes)" and both parties agreed to the allocation. In both agreements, the purchase price was allocated to real property and machinery and equipment, among other assets. Additionally, the agreement generally defined real property to include leaseholds and sub-leaseholds as well as any improvements, fixtures and fittings attached to the building. Equipment was generally defined within the agreement as tangible personal property such as machinery, equipment, computer hardware and software, furniture, automobiles, trucks, tractors, trailers, tools, jigs and dies. A few notable assets on the allocation schedule included a processing plant building, real property (specifically land and improvements), and machinery and equipment.

In its tax returns for the acquisition years, Peco depreciated the real property, including the processing plant building, as 39-year property. Several years later, Peco performed cost segregation studies for the acquired assets that resulted in reclassification of various real property assets into tangible personal property as either 7-year or 15-year depreciable property. Peco filed a Form 3115, Application for Change in Accounting Method, and subsequently filed tax returns that included favorable adjustments to reduce income tax liabilities due to the changes to depreciation.

In 2008, IRS issued a notice of deficiency attributable to the accounting method change, corrected depreciation adjustments for the real property and reduction to NOLs.

The Tax Court determined that none of these grounds for setting aside the agreement were present and Peco was therefore bound by the agreed to allocations.

Tax Court Rulings

The purchase agreement was subject to Internal Revenue Code Sec. 1060, which specifies allocation rules in determining the basis and gain or loss in an asset acquisition, and provides that, if the parties agree in writing as to the allocation of any consideration, or as to the fair market value of any of the assets, such agreement shall be binding on the parties. The allocation can be set aside only if IRS determines the allocation is inappropriate or the taxpayer can prove there was a mistake, undue influence, fraud, duress, etc., in the purchase agreement. The Tax Court determined that none of these grounds for setting aside the agreement was present and Peco was therefore bound by the agreed to allocations. Notably, IRS did not dispute the correctness of the allocations in the purchase agreements or the results of the cost segregation study. IRS challenged only the applicability of the post-agreement cost segregation reclassifications due to the binding nature of IRC Sec. 1060.

Among its arguments, Peco maintained that the purchase agreements were not enforceable because the definitions within the agreements of "Processing Plant Building" and "Real Property: Improvements" were ambiguous. The Tax Court determined they were not. With respect to one of the purchase agreements, the Tax Court noted that the allocation of almost twice as much of the purchase price to "machinery, equipment, and furniture" as to the "Processing Plant Building" proved Peco's intent to allocate the purchase price conclusively among the specific component assets. With respect to the other purchase agreement, the Tax Court noted that the decision to allocate the purchase price among various separate assets showed that Peco was aware of the existence of subcomponent assets but chose not to allocate additional purchase price to them. Additionally, the Tax Court noted in one circumstance that an appraisal was dated before the date of the agreement, suggesting that Peco could have adopted a more detailed allocation schedule but did not. The Tax Court also suggested that the timeline of events implied Peco believed in this ambiguity only after it understood it could receive a tax benefit by cost segregating the building into subcomponent assets.

The Tax Court concluded that Peco was bound by the allocations within the agreements and with IRS' adjustments.

Notably, IRS did not dispute the correctness of the allocations in the purchase agreements or the results of the cost segregation study.

Conclusion

This case points out a significant trap for the unwary that can be avoided. One key observation is if the parties want to agree to such a written purchase price agreement, they should carefully review the wording, definitions, and allocations of such agreements. Use of broad language such as "[the allocation] will be used for all purposes (including financial accounting and tax purposes)" needs to be considered carefully, as well as specific definitions within the agreement (e.g., "processing plant" instead of "processing plant building") to ensure desired results are achieved. Additionally, consideration should be given to performing a cost segregation study early in the process or draft the agreement in such a fashion that a subsequent cost segregation and allocation is binding on both parties.

It should be noted that an agreement of the parties on purchase price allocation is not required for tax purposes. If the parties choose not to agree, the residual method provided in regulations would be used and subsequent cost segregation studies may be beneficial to this allocation. ■

Restatements and Material Weakness – Income Tax Matters are Under the Spotlight

When public companies release their financial statements, investor expectations are that the financial statements are accurate and can be relied upon for making investment decisions.

Companies' financial statements are the responsibility of management. But what are the negative implications to management and the company's value if errors are discovered resulting in a restatement of financial results or an identification of a material weakness in the company's financial controls?

Financial reporting restatement and material weakness news has been flooding the business pages in recent years, forcing company management to reexamine internal controls and risk areas. Newly public companies, often with a higher risk of restatement, as well as long established companies concerned about material weaknesses, should focus on a prevalent risk area often overlooked: ASC 740 Accounting for Income Taxes. It is surprising to many that tax restatements are among the most frequent reasons for restatements, along with debt/equity issues and revenue recognition.

In a recent study by Audit Analytics, among 1,827 companies with initial public offerings (IPOs) since 2004, there have been 563 restatements. This high percentage in young company financial reporting occurs as newly public companies struggle in dealing with rapid growth without sophisticated internal resources for finance, accounting and tax. Tax related items were among the leading causes of these 563 restatements and contribute to roughly 8% to 12% of all restatements by U.S. Securities and Exchange Commission (SEC) registrants in recent years.

Mature public companies tend to have lower rates of restatement due to income taxes; however, the risk of material weakness related to income taxes is still of major concern. Public companies are required to disclose material weaknesses: deficiencies in internal controls over financial reporting for which it is reasonably possible that material misstatement will not be detected/pre-

vented. In recent years, accounting for income tax was the leading disclosed material weakness area. In 2010, insufficient review (quality, lack thereof, etc.) was cited as the number one contributor to tax-related material weaknesses. This isn't surprising given the complex nature of income tax laws and accounting for income taxes, which are often reviewed by management who are less familiar with these specialty areas of accounting.

No matter the size or age of the company, income tax accounting and related risks should be considered by management on an on-going basis. There are several steps management can take to remediate weaknesses surrounding the accounting for income tax processes. For example:

- Ensure the tax function is appropriately staffed or outsourced to proper specialists
- Provide income tax accounting educational opportunities not only to those responsible for tax but to accounting and finance management
- Improve communication between accounting/finance functions and those involved in the corporate tax function on a regular basis, including:
  - Formalize processes for tax-related reviews of new transactions, accounting policies, business functions and legal contracts
  - Define tax specialist input and review points surrounding on-going functions normally performed within accounting, such as fixed asset depreciation systems and lease accounting
  - Include tax specialists in regular accounting/finance communications regarding results and forecasts
  - Provide consistent guidelines to use across departments when making accounting estimates, including accounting for income tax estimate policies
- Include tax specialists in the overall evaluation of all tax positions taken
- Define and document the company's policy on tax procedures and reviews, including a consensus on risk tolerance levels

Management, utilizing the expertise of the tax function professionals, should perform thorough reviews of the accounting for income tax process, including reviews to identify weaknesses and risks. Once identified, internal control designs can be implemented or revised to best mitigate risk. Focusing on the review process and including the appropriately informed individuals should be a key focus of the control design. Upon implementation, the control process should be reviewed on a regular basis and upgraded with the growing tax needs of the company.

In many cases, the importance of the tax function of a company has not received the attention it is due when compared to other areas of a business. But with the continuing flow of restatements and identified material weaknesses in tax reported by public companies, the importance of income tax accounting has gleaned the attention of not only corporate boards and management, but also the SEC and now IRS.

Despite the complexities of ASC 740, early involvement by a highly qualified ASC 740 tax professional can help the company avoid an expensive and embarrassing restatement or a material weakness related to tax matters. ■

An Introduction to Hedge Funds

Amid the intense market volatility seen over the last several years, investors are looking for ways to mitigate adverse portfolio fluctuations.

Hedge funds, with their historically low correlation to traditional asset classes, respond to this concern (although correlations have started to increase considerably over the past three years). These alternative investment vehicles may offer investors added diversification and a better chance to outperform the market over a longer timeframe. However, before committing capital, investors should be familiar with all facets of hedge fund investing.

The term "hedge fund" is a broad category that commonly refers to a private investment fund managing a large sum of money at its own discretion, sometimes employing strategies to "hedge" against certain market risks. Perhaps the most defining characteristic of hedge funds is that they are subject to fewer regulatory requirements than traditional investments. This allows the hedge fund managers, who are usually experienced investment professionals, to use creative strategies that fully utilize their expertise and often provide investors with attractive risk-adjusted returns. Another defining characteristic is that they tend to be limited to accredited investors.

With few regulatory curbs on their investment strategies, hedge funds can use complex derivative instruments that reduce the correlations of their returns with the traditional asset classes. The main advantage of this is more diversification, as a hedge fund investment may act independently of broader market movements, which can provide a stabilizing effect on a portfolio during times of uncertainty. These added benefits have increased their popularity over the last few decades, with total assets increasing from $39 billion in 1990 to $2.13 trillion in the first quarter of 2012.

Hedge Fund Strategies

While particular strategies vary to a high degree, there are many strategies hedge funds use, which can be generally categorized as "directional" and "non-directional" strategies. Directional strategies try to take advantage of pricing inconsistencies in the market and often use leverage to maximize the returns earned on market swings. They tend to be more correlated with equity investments and the overall market. In contrast, non-directional strategies generally hedge against the risks of the market by using derivative instruments and short-selling techniques that may cause their performance to deviate widely from the market returns. These non-directional hedge funds tend to have lower correlations to the traditional asset classes, carry lower market risk (and lower expected returns) and are often used to reduce volatility in portfolios.

An alternative to investing in a single hedge fund strategy is to invest in a "hedge fund of funds." Hedge funds of funds allocate investors' money to a variety of hedge funds, covering multiple strategies and industries, which can provide an even greater level of diversification. This is a great investment for those who want to be exposed to a variety of hedge funds without committing a large sum of money to each of them. The biggest downside is their heightened fees, as the investor must pay fees to each underlying hedge fund as well as a fee for the fund of funds manager.

Hedge Fund Concerns

As with most alternative investments, hedge funds have some significant drawbacks that must be considered. One of the biggest concerns is the common industry practice of charging both regular management fees as well as incentive performance fees. This may result in large fees that erode the net performance of the investment. While performance fees can help align the manager's and investor's interests, they can also encourage excessive risk taking. Some hedge funds limit performance fees by setting a high water mark on performance fees, or setting a minimum hurdle rate that must be reached before they can begin to charge on positive returns.

Another common drawback is the lack of liquidity inherent with hedge fund investments. It is a standard in the asset class that investors may only redeem their money at a few specified intervals in the year, and they must notify the hedge fund in advance. Initial lock-up periods of one year are also commonplace. There is typically a portion of redemption proceeds that is held back until the annual audit of the fund is completed. Some hedge funds also have a gate provision which limits the amount of withdrawals investors can take from the fund.

Furthermore, hedge funds tend to have a lack of transparency. Although lighter regulatory requirements give hedge funds the ability to execute creative strategies, they also limit the information that must be reported to investors. Obtaining detailed holdings and performance information on a timely basis can be difficult, which also complicates tax planning and compliance. Most hedge fund investors will be forced to file tax returns on extension while waiting on receipt of a K-1, a tax form that reports the investor's share of the hedge fund activity for the year. When the K-1 is eventually received, it will frequently contain additional state income and foreign disclosure requirements, which can further complicate reporting and result in additional compliance fees.

While some hedge funds have generated very high returns in the past, there is also a risk of ending up on the other side of the equation. Some, but not all, hedge funds take on highly leveraged or highly concentrated positions. These and other unique investment and operational risks can put a more aggressive hedge fund at risk of catastrophic losses.

For investors who are concerned with high fees, compliance issues, lack of liquidity and transparency, and the loosely regulated nature of hedge funds, recent financial innovation has allowed for a different alternative. Hedge fund replication strategies are available in mutual fund and ETF structures, which are regulated under the Investment Company Act of 1940. These products have many of the same characteristics as traditional hedge funds, but eliminate some of the disadvantages by offering daily liquidity, transparency, reduced fees, efficient tax reporting and low investment minimums.

Conclusion

Hedge funds have become a significant part of the investment industry. Their ability to use unconventional strategies to provide diversification benefits makes them a very attractive addition to a balanced portfolio. Of course, they also come with a number of risks and consequences that investors must carefully consider before deciding hedge funds are right for their portfolio. Many institutional investors have hired in-house teams to provide their own due diligence on hedge fund managers. However, for the individual investor, it may be more feasible to work closely with your investment consultant with access to the resources necessary to effectively evaluate and monitor hedge fund management and performance. ■

NEWSWIRE

Update from the UK Tax Desk

In late March, the UK government published the 2012 Finance Bill enacting tax measures announced in the budget a week earlier, with a number of measures that could impact someone considering a move to the UK or a current or future investment in UK real estate.

Key highlights include:

- A reduction in the top income tax rate from 50% to 45%, effective April 6, 2013.
- Stamp Duty on residential real estate, effective March 21, 2012.
  - An increase in Stamp Duty to 7% on purchases of residential real estate of more than £2million by 'natural' persons.
  - A Stamp Duty of 15% on purchases of residential real estate of more than £2million by 'non-natural' persons (e.g., companies, partnerships and collective investments). This is aimed at combating perceived avoidance by using entity structures.
  - In addition, the government will further consult on the possible introduction of an annual charge on 'non-natural' persons holding UK residential real estate as well as a potential capital gains tax charge.
- Statutory Residence Test. The Bill confirms that the introduction of the new statutory test for determining UK residence originally targeted from April 6, 2012 has been deferred until April 6, 2013.
- Effective April 6, 2012, the non-domicile remittance basis charge will increase to £50,000 for UK resident non-domiciled individuals who have been resident in the UK for any part of a tax year in 12 of the previous 14 tax years and who wish to continue benefiting from the remittance basis of taxation. The £30,000 charge still remains for those who have been resident for seven out of the previous nine tax years.
- The corporation tax rate of 25% (from April, 2012) will be further reduced to 24% from April, 2013 and 23% from April, 2014.

WTAS is one of the largest independent tax firms in the United States, providing a wide range of tax, valuation, financial advisory and related consulting services to individual and corporate clients across the country. The firm is comprised of over 500 personnel located in 14 major cities and encompasses top advisors with previous experience in the international accounting firms, law firms, the IRS and state taxing authorities. Our advisors hold multiple professional credentials and have depth in a wide range of capabilities allowing us to provide clients with comprehensive, integrated solutions.

WTAS Offices & Office Managing Directors

Chief Executive Officer
Mark Vorsatz
(415) 764-2784

Baltimore, MD
David Bradt
(443) 539-8000

Boston, MA
Joseph Comeau
(617) 292-8400

Chicago, IL
Joseph P. Karczewski
(312) 357-3950

Greenwich, CT
Daniel G. DePaoli
(203) 987-3660

Harrisburg, PA
George T. Lyons
(973) 210-7062

Madison, NJ
George T. Lyons
(973) 210-7062

Los Angeles, CA
Kurt Brune
(213) 593-2300

New York, NY
Joseph P. Toce, Jr.
(646) 213-5100

Palo Alto, CA
J. Martin O'Malley
(650) 289-5700

Philadelphia, PA
George T. Lyons
(215) 654-1600

San Francisco, CA
Frank R. Cassidy
(415) 764-2700

Seattle, WA
Susan Swartz
(206) 577-7880

Washington, D.C.
David Bradt
(571) 382-0020

West Palm Beach, FL
Michael Kohner
(561) 805-6550

Managing Directors

Abbin, Byrle – Washington, D.C.
Ackel, Rick – San Francisco, CA
Alberga, Lilli I. – San Francisco, CA
Amon, William J. – Los Angeles, CA
Amster, Susan K. – Los Angeles, CA
Anderson, Eric – San Francisco, CA
Anderson, Pat – Washington, D.C.
Ankrah, Sonny – Philadelphia, PA
Avigdor, Efrat - New York, NY
Bernard, Andrew – Philadelphia, PA
Blair, David – San Francisco, CA
Bonito, Ellen - New York, NY
Booth, Jeremy – New York, NY
Bradt, David — Washington, D.C.
Broderick, Tom – San Francisco, CA
Brune, Kurt — Los Angeles, CA
Burns, Kevin – Chicago, IL
Calister, Marilyn B. – New York, NY
Cassidy, Frank R. – San Francisco, CA
Castagne, Matthew - New York, NY
Chan, Nancy – Los Angeles, CA
Chubb, Charles M. – Philadelphia, PA
Cole, Dick – Los Angeles, CA
Comeau, Joseph — Boston, MA
Coombs, Luke – Baltimore, MD
Corrick, Stephen R. – Washington, D.C.
Coscia, Peter – New York, NY
Culhane, Edward – Boston, MA
Dannemiller, Jason – Seattle, WA
DeGirolamo, Joseph A. – San Francisco, CA
DePaoli, Daniel G. – Greenwich, CT
DesRoches, Gerald D. – New York, NY
Dolabson, Keith S. – Los Angeles, CA
Epstein, Armand – Boston, MA
Farro, John - New York, NY
Feria, Dean – West Palm Beach, FL
Fiore, Carl C. – New York, NY
Freda, Raymond – New York, NY
Freeman, David – Chicago, IL
Girard, Matthew – Philadelphia, PA
Goode, Jim – Boston, MA
Graham, Jason C. – San Francisco, CA
Guidice, Steven – New York, NY
Handa, Kurtis – San Francisco, CA
Hernandez, Sandra Y. – Los Angeles, CA
Hough, Michael – Boston, MA
Iwicki, Catherine – Seattle, WA
Jahn, Richard – New York, NY
Karczewski, Joseph P. — Chicago, IL
Kies, Bob – Los Angeles, CA
Kluemper, Joseph R. – New York, NY
Kohner, Michael — West Palm Beach, FL
Kyriacou, Andrew – Boston, MA
Lamprecht, Lance – Seattle, WA
Loer, Petra – San Francisco, CA
Lopez, Daniel – Los Angeles, CA
Love, Deana – West Palm Beach, FL
Luckenbach, Sid – San Francisco, CA
Lyons, George T. – Madison, NJ
Macpherson, Randolph – West Palm Beach, FL
McDonnell, Thomas R. – Philadelphia, PA
McGee, Debbie S. – Los Angeles, CA
Minich, Dennis – Chicago, IL
Morisky, Richard – San Francisco, CA
Mullen, John H. – San Francisco, CA
Nager, Ross – Houston, TX
Numair, Susan B. – San Francisco, CA
O'Malley, J. Martin — Palo Alto, CA
Pace, William M. – Los Angeles, CA
Peng, Janet – New York, NY
Pepin, Dorice – Chicago, IL
Percella, Angela – New York, NY
Pike, Ralph – Chicago, IL
Prifti, Robert – Boston, MA
Raaf, Jim – Chicago, IL
Rice, Chris – Seattle, WA
Roberts, David – New York, NY
Ruecker, Norman H. – San Francisco, CA
Schneidman, Len – Boston, MA
Seery, Brian – Los Angeles, CA
Shepard, Yichen – San Francisco, CA
Skrip, Martin J. – San Francisco, CA
Spiegelman, Chris – Greenwich, CT
Steinberger, Adam – Palo Alto, CA
Stroup, Keegan F. – Washington, D.C.
Swartz, Susan — Seattle, WA
Tauber, James – Chicago, IL
Thomas, Scott – Boston, MA
Thornson, Raymond L. – San Francisco, CA
Tillett, Monica – Washington, D.C.
Toce, Joseph P. Jr. — New York, NY
Ullsperger, Brian – Washington, D.C.
Ventress, Michelle – Chicago, IL
Vorsatz, Mark – San Francisco, CA
Weicher, Michael – New York, NY
Wilcox, Ron – Los Angeles, CA
Zemsky, Kenneth T. – New York, NY