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Partnering with Guidance

Recent legislation has changed the landscape for partnerships and limited liability companies ("LLCs") and their partners and members.

While the regulatory environment has evolved over some time, 2013 has ushered in significant changes that call for a new focus on tax planning and administration. Tax rates have increased, the list of taxpayer disclosure requirements continues to grow, and there has been an uptick in audit activity at both the federal and state levels. This article will highlight some of the major legislative changes and provide some helpful insights for navigating through them.

Medicare Contribution Tax

The Patient Protection and Affordable Care Act ("PPACA") has added a new dimension to the taxation of pass-through income. The PPACA, signed by President Obama on March 23, 2010, has been one of the most fervently debated pieces of legislation in recent memory – and it appears it is here to stay. One of its main components, which went into effect on January 1, 2013, is the imposition of a 3.8% tax on net investment income for certain high-income taxpayers – codified as the Medicare contribution tax. The term "net investment income," for purposes of the Medicare contribution tax, includes items such as interest, dividends, and capital gains less certain expenses. Perhaps most importantly, net investment income includes net income from passive activities. Passive activities are trades or businesses in which the taxpayer does not materially participate. To materially participate, or to be considered "non-passive," a taxpayer must be involved in the operation of the activity on a regular, continuous, and substantial basis. Such involvement, per IRS regulations, is measured by certain tests that take into account the number of hours a taxpayer spends operating or otherwise managing the trade or business.

Taxing passive income under the PPACA has effectively changed the setting for non-participatory investors in operating businesses. For the typical high-income passive investor, income from an operating business will be subject to an additional layer of tax, at 3.8%, which mirrors the Medicare portion of self-employment tax paid by owner-operators, also at 3.8% starting in 2013. One item to note is that the passive investor will not be allowed the benefit of a deduction for one-half of the additional tax paid as is the self-employed individual. Additionally, IRS has proposed regulations that could result in situations where taxpayers with a net investment loss still owe the Medicare contribution tax. This is possible under the proposed regulations because of the procedures for allocating expenses between net investment and self-employment income. The effects of the new tax are not limited to partners and partnerships. S corporation shareholders are not subject to self-employment tax on business income flowing through the corporation. If, however, a shareholder's interest in the S corporation is deemed passive (i.e., the shareholder does not materially participate), any business income generated would be subject to the 3.8% tax.

Alternative investment funds are in the crosshairs of this tax since the income they generate is typically classified as passive to the majority of their investors. Further, income from trading hedge funds generally treated as non-passive is specifically included in net investment income, thereby subjecting almost all income earned by investors in alternative investment funds to the Medicare contribution tax.

Although the imposition of the Medicare contribution tax affects many taxpayers, there are planning opportunities. A partner who invests in multiple pass-through entities can use passive losses from one activity to offset passive income of another. Certain taxpayers, for example, could benefit from how they group their passive activities in order to minimize the net passive income subject to the tax. Also, for managers, there are certain situations that, with proper execution, can reduce the amount of income subject to both the Medicare contribution tax and self-employment tax.

Increased Audit Activity for Partnerships in 2014

Also on the horizon, IRS is examining ways to increase audit activity of partnerships and other pass-through entities beginning in 2014. Late last year, Faris Fink, Commissioner of IRS Small Business/Self-Employed Division ("SB/SE"), commented at an AICPA meeting that the division will be increasing audit activity for partnerships in 2014. To prepare for this, SB/SE has been developing new procedures for selecting the right partnership audit targets as well as for conducting the audits themselves. In anticipation of these measures, partners and partnerships should take action to protect themselves from unwanted IRS scrutiny.

There are certain fundamental and common missteps that, with proper attention, can be avoided. In today's fast-paced business environment, it is not uncommon for an entrepreneur to jump at an opportunity as it arises and only ask vital tax questions after the smoke has cleared. In most cases, asking the right questions when it is already too late can lead to substantial – and costly – inefficiencies in an individual's overall tax posture. Before starting or joining a new venture, there are several questions a taxpayer should consider:

- Will I receive a profits or equity interest in exchange for my services?
- Do I need to make an 83(b) election?
- If purchasing an interest from existing partners, is a 754 election needed?
- Does my agreement comply with current tax laws?
- Have I transferred marketable securities or any property other than cash to a partnership in exchange for an ownership interest?
- Could this venture have an impact on my estate plan?
- How should income and expenses be allocated?

Asking questions like these at the outset can help set the framework for a solid structure that is both tax efficient and resistant to IRS challenges.

Once the aforementioned matters are vetted and a structure is in place, the major areas requiring consideration are operations and documentation. If a partnership operates as the partners intended and it has adequate supporting documentation, the risk of a successful IRS challenge will be minimized. A legally and economically sound partnership agreement should be properly executed by all partners. The partnership's books and records should be properly maintained along with bank records to substantiate cash transactions. Capital accounts must also be properly maintained and reflect the economic agreement among the partners. The partnership must retain any materials documenting contributions of assets into the entity. Likewise, any distributions to the partners should be documented and made in accordance with the terms of the partnership agreement.

These are areas on which an audit would likely focus and they require diligence from the parties involved. Proper accounting and administration is conducive to accurate reporting and that above all will pose the greatest defense to an IRS audit.

FATCA

The Foreign Account Taxpayer Compliance Act ("FATCA") is scheduled to come into effect for pass-through entities beginning on July 1, 2014, and steps should be taken to comply with its burdensome reporting requirements. This new legislation is an important development in U.S. efforts to improve tax compliance involving foreign financial assets and offshore accounts. FATCA's rules are complex and the following is intended to provide only a general overview.

FATCA requires U.S. and non-U.S. financial institutions, such as private equity and hedge fund sponsors, to provide information to IRS regarding their U.S. investors or be subject to onerous withholding rules. Such foreign entities, under FATCA, fall under a broad category known as foreign financial institutions ("FFI"). FATCA withholding subjects all payments of U.S. source income to a noncompliant FFI to a 30% gross basis withholding tax – even on such items of income that are currently exempt from withholding (e.g., portfolio interest). Certain FFIs can avoid FATCA withholding by entering into an agreement and registering directly with IRS in order to substantiate that they are FATCA compliant and their reporting obligations have been fulfilled. Not leaving much to chance, IRS intends to publish a list of compliant entities on its website in June 2014. FFIs have until April 25, 2014, to register thereby ensuring inclusion on the first published list and, in most cases, avoid being subject to the 30% withholding tax. While the legislation's provisions are directed chiefly at foreign financial and investment-type entities, domestic partnerships will receive a share of the burden as well. U.S. payors must fulfill certain documentation requirements with respect to foreign payees and, otherwise, must withhold 30% on payments of U.S. source income attributable to such payees.

With both deadlines fast approaching, U.S. and non-U.S. entities that could potentially fall under FATCA's provisions should immediately begin implementation of internal procedures for compliance. In addition to registration with IRS, an entity's main focus should be identifying assets and investors that would subject the entity to FATCA reporting and then to acquire the appropriate documentation to avoid falling under the 30% withholding tax provisions. Both the withholding agent (partnership) and the payee (investor) could be subject to significant civil and criminal penalties for non-compliance.

Conclusion

As a result of changes in the regulatory environment that have taken shape this year, along with others on the horizon, the need for tax planning and compliance procedures for partnerships and LLCs has never been more important. The Medicare contribution tax, imposed under the PPACA, attempts to level the playing field by taxing certain types of income, but there are ways to help alleviate some of its impact. Taxpayers also face the task of instituting new procedures to comply with FATCA's disclosure requirements or instead face the risk of sizable withholding taxes and penalties. Know what to do to ensure compliance and to be ready for the additional administrative burden. In conjunction with increased regulations, IRS is looking to improve the way partnership audit candidates are identified so that it can increase the number of successful audits. Taxpayers can protect themselves, though, by following some fundamental guidelines for forming and operating the partnership. Don't go it alone. The time is right to seek guidance from a professional tax advisor.

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Managed Futures: The Search for Non-Correlation

Traditional wisdom suggests that diversifying among asset classes will smooth out returns and reduce overall risk in an investment portfolio.

Unfortunately, most traditional asset classes have recently become highly correlated. That is, they have been moving up or down in tandem, diminishing the benefit of diversification. In a quest for non-correlated assets, sophisticated investors frequently look beyond traditional stocks and bonds to include alternative investments. One such alternative with favorable correlation characteristics may be found in managed futures strategies.

Managed futures strategies can improve the risk-return tradeoff in a long-term asset allocation portfolio, yet few investors consider it as an asset class. Their obscurity is perhaps owed to a lack of understanding of the specific role they can play in diversified portfolios, but managed futures strategies have historical performance characteristics that make them highly relevant in a market environment of relatively low returns and generally rising asset class correlations.

Initially, managed futures strategies focused solely on metals and grain futures, but became commonplace in the 1970s after futures exchanges expanded to include new types of futures contracts. Presently, managed futures strategies encompass both long and short investments across commodities, equities, currencies, interest rates, and government bonds futures. Popularity of the asset class has increased since its strong performance during the dot-com collapse of 2000-2002 and the financial crisis in 2008. Despite a successful track record, however, managed futures remain an asset class unfamiliar to many investors.

The primary driver of most managed futures strategies is trend-following or momentum investing; that is, buying assets that are rising and selling assets that are declining. This type of strategy's most powerful attribute is the potential to do well in either extremely strong or extremely weak markets. By doing well when most traditional asset classes are suffering, a compelling statistic results. Historically, managed futures have displayed virtually no correlation to the S&P 500 Index or the Barclays Capital Aggregate Bond Index, offering strong portfolio diversification potential.

Momentum investing is supported by modern behavioral economics theory, which links human behavior to under- and over-reactions in market prices. You may ask, "How can a price trend be predicted and profited from?" Consider, for example, a positive catalyst that justifies a higher intrinsic value of an asset. As the behavioral economics theory proposes, investors' anchoring biases may mute their reaction to new information causing new price estimates to remain tethered to old prices. After the initial under-reaction and once the catalyst has been widely accepted and disseminated, herding behavior can push prices beyond the asset's fundamental value. The same example can apply to negative catalysts where the behavioral pattern would simply be inverted. This behavioral explanation implies that investors may be less rational than many market theories assume, a conclusion supported by a growing group of behavioral economists.

Since the prerequisite for positive performance of such managed futures strategies is a sustained and consistent trend in market futures prices, they tend not to perform as well in other market conditions. These environments include periods without sustained moves in one or more of the markets traded, so-called *whip-saw* markets, in which trends appear to develop but then quickly reverse. Other environments where these strategies may underperform are markets that are driven by factors or events not reflected in technical analysis. In 2011 and 2012, political aggravations, natural disasters, global central bank policies, and a general "risk-on, risk-off" investor mentality left markets choppy and directionless. These conditions produced negative returns for most managed futures strategies during that time period.

For many years, hedge funds were the only vehicles through which investors could access managed futures. However, this strategy has become considerably more accessible now that it is also available through mutual fund vehicles with reduced fee structures, increased liquidity, greater transparency and simpler tax compliance. As of May 31, 2012, there were 31 managed futures mutual funds comprising total assets under management of nearly $9 billion.

Despite the perceived complexities, managed futures strategies should warrant further exploration. With the ability to invest both long and short across multiple assets classes, managed futures strategies have characteristics that may help investors address the problem of rising asset class correlations. As recent events have illustrated, geographic diversification may no longer be sufficient to help investors reduce portfolio risks. Those seeking new and potentially more effective ways of diversifying may wish to consider adding managed futures strategies to their portfolios, given the strategy's track record of low correlations coupled with its upside return potential.

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Professional Athletes - Taxing to the Mind, Body and Wallet

A professional athlete seems to have the greatest job on earth. It comes with wealth, glamour and fame.

However, it also exposes the athlete to attention that is not wanted. This article will discuss the very "unwanted" attention of the state taxing authorities.

Most people live and work in the same city or town and have a fairly simple tax preparation process. The average person files a federal, state and possibly city return, depending on his or her place of residence. Athletes, on the other hand, practice and play all over the country and in many cases, the world. Many jurisdictions have the authority to tax individuals performing services within their borders. Therefore, athletes may be required to pay taxes to each city, state, and country where they practice or play.

The average athlete may travel to 20 or more different jurisdictions throughout a single season, which can create a tax compliance nightmare. This situation is sometimes called the "jock tax" because the nature of an athlete's profession makes him or her very susceptible to this type of taxation.

Why Athletes are a Tax Target

States see athletes as juicy targets to extract tax revenue particularly during a time of tight budgets. Between the NFL, NBA, MLB, and NHL, there are over 120 professional sports teams whose players each earn an average of between $1 million and $5 million per year depending on the sport. Each time a puck is dropped, touchdown is scored or player suits up for practice, a taxing jurisdiction expects to receive tax on its share of a player's earnings.

Because of the large amount of revenue involved, many states, like California, have specific tax agents who deal exclusively with professional athletes. Since the salaries and schedules of a professional athlete are publically available, it is very easy for a state tax official to track the revenue that may be subject to tax. This makes return accuracy even more important from an audit perspective.

How Taxable Income is Apportioned for Athletes

Not all taxing jurisdictions use the same method for determining how much of a player's income is subject to tax. For athletes that play on a team, many, but not all, states use the "Duty Days" method. A "Duty Day" is effectively a day of service on which a player is required to perform in his or her capacity and can include both game days and practice days. The "Duty Days" approach apportions a player's income based on the number of days that a player performs services in a particular jurisdiction as compared to the total numbers of days on which services are performed. For example, if a baseball player earns a salary of $3 million for a particular season, and spends 15 out of his 200 duty days in the state of Arizona, the player will apportion $225,000, or (15/200 * $3 million) of income to that state. Different jurisdictions may use various definitions as to what constitutes a day of service or they may use another methodology altogether. Another such methodology is the "Games Played" method. This method apportions income to a jurisdiction based on only the number of games played in that particular jurisdiction as compared to the total number of games played in a year.

It is important that a tax advisor be aware of the interplay between the different methodologies. Depending on the methodology used in the various states, income could be double taxed or an opportunity to significantly mitigate tax liability may be available. This will also, of course, be dependent upon the athlete's state or country of residency. Athletes who are not part of a team, such as golfers, are taxed in a particular jurisdiction on the income earned from a tournament or event played in that jurisdiction.

Endorsement income is another source of revenue for many professional athletes. In general, for an endorsement contract that requires a player to perform in a specific event or location, the income is usually sourced to that location. This could include using a specific brand of golf club or wearing a certain brand of clothing at a tournament. If the contract merely uses the player's likeness or image, then the income will likely be sourced to the player's home state. An example of this would be the income from a national advertising campaign for an athlete's support of a particular product or brand.

Tax Withholding and Reciprocal Agreements

Professional sports teams withhold federal, state and city taxes on a player's behalf. Frequently, the tax withholding does not align with the actual liability as computed by a jurisdiction's taxing methodology. It is important for a tax advisor to be aware of this as an athlete may be significantly overpaid or underpaid in several jurisdictions.

Therefore, an athlete can be in a situation where he or she is entitled to sizable refunds in some states while owing large balances in others. These timing differences can have a significant impact on an athlete's cash flow.

A player's withholding can also be incorrect if reciprocal tax agreements exist. These are agreements where taxing jurisdictions agree not to tax each other's nonresidents. Examples of states with reciprocal agreements are Indiana, D.C., Pennsylvania and Ohio.

Athletes can capitalize on the benefits of these agreements by submitting a withholding exemption form to their employer. Failing to do so will not deprive them of the agreement's benefits, but it will cause them to have a significant amount of taxes paid to a jurisdiction to which they legally owe nothing. Again, an athlete can end up with severe cash flow issues if their advisors are not aware that these agreements exist.

It's important to recognize that athlete's activities can be international in nature. The NFL plays at least one game per year in London and the NHL, NBA and MLB all have Canadian franchises. Tax advisors need to be aware of how foreign tax rules and tax treaties can affect an athlete's tax liability. Some tax treaties have provisions that deal specifically with professional athletes. This is a complex area of the tax law and professional guidance should be sought in navigating the web of international tax rules.

Deductibility of Expenses Unique to Athletes

Athletes, in particular, have certain expenses unique to their profession such as agent's fees, clubhouse expenses and certain sports equipment. Team athletes are considered employees and therefore, many of these deductions are considered itemized deductions subject to a 2% of AGI limitation. As allowable itemized deductions were further limited starting in 2013 by the return of the Pease amendment, it is very important to work with a tax adviser to time these payments, particularly large agent's fees, in order to maximize their deductibility. Individual, non-team, athletes are afforded more flexibility with regard to their professional expenses as they are considered self-employed persons.

The unique nature of the professional sports business can make tax compliance a nightmare for many athletes. Not only is the tax burden itself large and wide-reaching, but the added spotlight due to their publicity makes getting it right even more important. Aside from the federal tax filings, there are many nuances of interstate taxation that a tax advisor needs to be aware of such as the "Duty Days" and "Games Played" apportionment methodologies, tax withholding, endorsement income, interstate reciprocal tax agreements and athlete specific expenses. Diligence, planning, and foresight can go a long way in saving an athlete on their tax bill and eliminate the stress associated with short-term cash flow issues. A skilled tax advisor can help the professional athlete navigate this maze and keep the player's focus on doing what they do best, winning.

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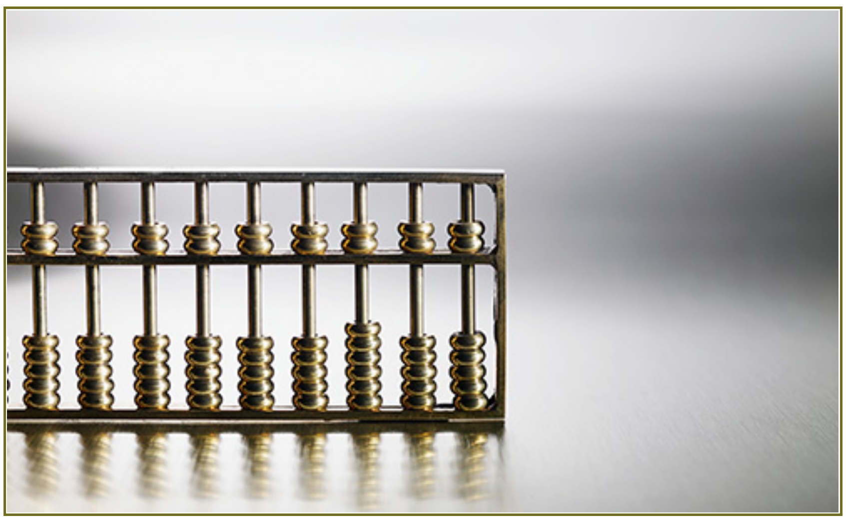
Valuing Pension Benefits



Upon the death of a pension plan recipient, survivor benefits may be distributed to a spouse or other beneficiary.

A valuation may then be necessary to determine the fair market value of the pension plan for estate tax reporting purposes. Determination of fair market value is a matter of judgment, however, and in valuing a pension plan, or interest thereof, four variables in particular are analyzed: expected cash flows; expected term of the cash flow stream; counterparty risk; and the illiquidity of the pension benefits.

The first step in the valuation process is to quantify anticipated cash flows. Such cash flows are based on the structure and term of the pension plan, as well as projected performance of the underlying investment portfolio at such point in time. The determination of the expected cash flows is generally specified by the plan's documents in the case of a defined benefit plan.

Additionally, since the value of a pension plan is intrinsically tied to the timing of the payouts, one must estimate the term of the pension benefits. In scenarios in which a beneficiary receives benefits until his or her death, actuarial estimates of life expectancy and annual mortality rates should be utilized. The mortality rate in each year is then applied to the value of the potential cash flows to yield the actuarially expected value of the cash flows.

In order to calculate the present value of the pension benefit stream, an appropriate risk-adjusted discount rate must be applied. This discount rate incorporates the time value of money as well as the risk attributable to the uncertainty of a company's ability to repay such obligations. For many well-capitalized companies, a general corporate bond yield, such as the yield on Moody's Baa-rated companies, can be utilized as a proxy for the credit-risk-adjusted discount rate. However, as a result of the "Great Recession" and subsequent low interest-rate environment, corporate pension funding deficits have grown to historic levels. Whether or not one's stated benefits are at risk of being cut, an inadequately funded pension plan will increase potential shortfall risk. Thus, the risk associated with the funding status of the pension must be considered in addition to the overall financial health of the corporate issuer of the plan.

An interest in a corporate pension plan is not publicly traded, and thus, cannot be converted to cash quickly or easily. One method to liquidate a pension benefit is for a beneficiary to enter into an over-the-counter financial instrument (swap), in which the future pension benefit streams are exchanged for a fixed stream of payments or lump-sum payment. However, one might incur significant fees and costs through this type of transaction. Thus, when valuing the fair market value of such benefits, adjustments for the lack of liquidity should be considered, either as an adjustment in the discount rate or separately as a discount for lack of marketability.

For pension beneficiaries, estate planners, and executors, it can be critical to understand these key value drivers when faced with the challenging task of valuing future pension benefits. Thus, it is always advisable to seek the expertise of a qualified professional, who can help evaluate all the qualitative and quantitative factors and opine on an accurate and defensible conclusion of value.