Strafford

Presenting a live 110-minute teleconference with interactive Q&A

Taxation and Financial Reporting of Investments in Securities and Related Complex Transactions

Tackling Financial Statement Challenges and Tax Consequences of Timing, Character and Source

TUESDAY, SEPTEMBER 10, 2013

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Laura L. Ross, CPA, Partner, **EisnerAmper**, San Francisco

Renee Ford, Assurance Principal, **Decosimo**, Chattanooga, Tenn.

Elizabeth Powell, Senior Manager, **Decosimo**, Chattanooga, Tenn.

For this program, attendees must listen to the audio over the telephone.

Please refer to the instructions emailed to the registrant for the dial-in information. Attendees can still view the presentation slides online. If you have any questions, please contact **Customer Service at 1-800-926-7926 ext. 10**.

Tips for Optimal Quality

FOR LIVE EVENT ONLY

Sound Quality

Call in on the telephone by dialing **1-866-873-1442** and enter your PIN when prompted.

If you have any difficulties during the call, press *0 for assistance. You may also **send us a chat** or e-mail **sound@straffordpub.com** immediately so we can address the problem.

Viewing Quality

To maximize your screen, press the F11 key on your keyboard. To exit full screen, press the F11 key again.

Continuing Education Credits

Attendees must stay on the line throughout the program, including the Q & A session, in order to qualify for full continuing education credits. Strafford is required to monitor attendance.

Record verification codes presented throughout the seminar. If you have not printed out the "Official Record of Attendance," please print it now (see "Handouts" tab in "Conference Materials" box on left-hand side of your computer screen). To earn Continuing Education credits, you must write down the verification codes in the corresponding spaces found on the Official Record of Attendance form.

Please refer to the instructions emailed to the registrant for additional information. If you have any questions, please contact **Customer Service at 1-800-926-7926 ext. 10**.

Program Materials

FOR LIVE EVENT ONLY

If you have not printed the conference materials for this program, please complete the following steps:

- Click on the ^ sign next to “Conference Materials” in the middle of the left-hand column on your screen.
- Click on the tab labeled “Handouts” that appears, and there you will see a PDF of the slides and the Official Record of Attendance for today's program.
- Double-click on the PDF and a separate page will open.
- Print the slides by clicking on the printer icon.

Taxation and Financial Reporting of Investments in Securities and Related Complex Transactions

Sept. 10, 2013

Laura L. Ross, EisnerAmper
laura.ross@eisneramper.com

Renee Ford, Decosimo
reneeford@decosimo.com

Elizabeth Powell, Decosimo
elizabethpowell@decosimo.com

Today's Program

Notice

ANY TAX ADVICE IN THIS COMMUNICATION IS NOT INTENDED OR WRITTEN BY THE SPEAKERS' FIRMS TO BE USED, AND CANNOT BE USED, BY A CLIENT OR ANY OTHER PERSON OR ENTITY FOR THE PURPOSE OF (i) AVOIDING PENALTIES THAT MAY BE IMPOSED ON ANY TAXPAYER OR (ii) PROMOTING, MARKETING OR RECOMMENDING TO ANOTHER PARTY ANY MATTERS ADDRESSED HEREIN.

You (and your employees, representatives, or agents) may disclose to any and all persons, without limitation, the tax treatment or tax structure, or both, of any transaction described in the associated materials we provide to you, including, but not limited to, any tax opinions, memoranda, or other tax analyses contained in those materials.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

Laura L. Ross, EisnerAmper

INTRODUCTION

Renee Ford, Decosimo

FINANCIAL REPORTING AND ACCOUNTING ISSUES

Accounting for Investments in Equity Securities

- Non-investment companies versus Investment Companies – at a glance
- Fair value measurement and disclosures for complex equity securities
- Sales and investment income from equity securities
- Foreign investments – special considerations

Accounting for Investments in Equity Securities

- Non-investment companies – ASC 320
  - Basis of Accounting –
    - Fair value or cost
    - Equity method or consolidation
  - Classification – Trading, Available for Sale, Held to Maturity
  - Holding Gains and Losses –
    - Trading – included in current earnings
    - AFS – other comprehensive income until realized, net of tax
  - Realized Gains and Losses –
    - Trading – no effect on net earnings
    - AFS – previous OCI reversed into earnings
    - HTM – included in current earnings

Accounting for Investments in Equity Securities

- Investment companies – ASC 946 and ASC 820
  - No “classification” - all investments carried at fair value
  - Equity method and consolidation do not apply
  - Holding Gains and Losses –
    - On balance sheet as unrealized gain/loss with change included in current earnings
  - Realized Gains and Losses –
    - Included in current earnings
  - Relevant standards –
    - Fair value is defined in ASC 820
    - Investment company financial reporting – ASC 946
    - Investments in derivative instruments – ASC 815
    - Registered funds – SEC regulatory guidance on valuation

Accounting for Investments in Equity Securities

For purposes of this presentation, we will focus only on accounting and reporting of investment securities from the Investment Company perspective.

Valuation of Investments in Equity Securities

- ASC 820 prescribes 3 methods of fair value measurement –
  - Market, cost and income approaches
  - Appropriate method(s) will vary by security
  - Defined as "exit price", not entry price
    - Except for use of transaction price at initial recognition
    - Exit price not adjusted for transaction costs
- Fair value hierarchy -
  - Level 1 inputs – quoted prices in active markets for identical securities
  - Level 2 inputs – observable inputs for similar securities
  - Level 3 inputs – unobservable inputs

Valuation of Investments in Equity Securities

- Level 1 -
  - Publicly-traded stock, related puts/calls, mutual funds, securities sold short
    - End of day market quotations (last quoted sales price)
    - No adjustments needed, relatively straight-forward

- Level 2 and 3 –
  - Publicly-traded stock but no active market
  - Private equities, preferred stock, convertible securities, investments in other investment companies
    - More complex, involves multiple inputs that may be both observable and unobservable

Valuation of Investments in Equity Securities

- Publicly-traded, no active market
  - Must still assume sale takes place at valuation date
  - Reporting entity's intent to hold the security is not relevant (market-based measurement vs. entity-specific)
  - May use pricing services or brokers for quotations of bid price and asked price and use mean
  - May use bid price alone (ask price alone for shorts)
  - May not use ask price alone (or bid alone for shorts)
  - If spread between bid and ask is substantial, consider quotes for several days

Valuation of Investments in Equity Securities

- Private equities – common approaches to fair value
  - Comparative Sale approach
  - Multiple of earnings approach
  - Appraisal or Third Party Quote
  - Enterprise Value Waterfall approach
    - Enterprise value of portfolio company is allocated to the company's securities in order of relative liquidation preference.
    - Enterprise value is based on appropriate fair value model.

Valuation of Investments in Equity Securities

- Preferred Stock –
  - Characteristics of both equity and debt
    - May or may not participate in earnings
    - Generally carry a dividend requirement similar to interest
    - Dividends may be cumulative or noncumulative
  - Valuing Preferred Stock of Private Companies –
    - Value tied to current dividend yield compared to similar public company and characteristics of the shares themselves, if company is able to pay dividends
    - If convertible to common, value may be based on value of equivalent common shares if "in the money"
    - Valued at par (stated liquidation value) if weak financial position or unable to pay dividends, unless net assets are insufficient

Example of preferred stock valuation:

- XYZ, Inc. 100K shares, Series A Cumulative Preferred Stock (12.9%), purchased at $6 per share (stated value) on 1/1/12
  - Value at 12/31/12 assuming XYZ is in developmental stage, experiencing losses, not yet paying accrued preferred dividends, net assets available to owners if liquidated are $1.4MM.
    - $600,000 stated value
    - Unpaid dividends are evaluated for collectability
  - Same as above, but available net assets are $500K?
    - $500,000

- XYZ, Inc. 100K shares Series A Convertible Preferred Shares (12.9%), purchased at $6 per share (stated value) on 1/1/12, convertible to 3 common shares each
  - Value at 12/31/12 assuming company is slightly profitable and common shares are trading at $2.50.
    - $750,000, which is value of equivalent common shares if converted

Valuation of Investments in Equity Securities

- Convertible Debt Instruments –
  - Debt convertible to common or preferred shares
    - Represents a debt instrument with an embedded equity derivative (option-based derivative)
    - Investment companies apply fair value accounting to the entire instrument as a whole
    - Marketable debt instruments may have quoted values or values based on cash flow models
    - Private debt usually carried/valued at amortized cost unless impaired or if conversion feature is "in the money"
  - Conversion –
    - Cost basis plus any conversion premium carries over to new securities received
    - Conversion terms can vary widely, may affect accounting

Valuation of Investments in Equity Securities

- Investments in other investment companies –
  - i.e. - Hedge funds, private equity funds, real estate funds, venture capital funds, funds of funds
  - Subscriptions increase cost basis
  - Redemptions decrease cost basis and may result in realized gain/loss
  - Can estimate fair value based on reported net asset value per share (NAV) if measured consistent with ASC 946 as of reporting entity's measurement date unless probable of being sold for less in near term
    - "Practical expedient" and level 2 categorization if redeemable
    - If practical expedient not available – level 3 categorization

Slide Intentionally Left Blank

Other Presentation Matters

- Securities sold short –
  - Shown in balance sheet as a liability, generally
  - Measured at fair value of securities borrowed
  - Difference between proceeds received and fair value of securities borrowed is unrealized gain/loss
- Offsetting positions –
  - Unless exception for net presentation are met, positions are presented separately, at gross amounts
  - Exception for entities that who manage certain market or counterparty risks on a net basis
    - May present at net, but only if requirements are met –
      - Documented “net” risk mgmt strategy

Disclosures for Equity Securities Investments

- Disclosures required by ASC 820 – Fair Value
  - Description of methods and inputs used to measure fair value
  - Fair value hierarchy by type of investment
  - Rollforward of investments categorized in level 3
  - Qualitative and quantitative disclosures about level 3 inputs used to measure fair value (example following)

- Disclosures required by ASC 946 – Investment Companies
  - Portfolio of investments, by country/industry/5%
  - Redemption terms and investment strategies of significant investments in other investment companies

Example of Quantitative and Qualitative Level 3 inputs

The following is quantitative information about significant unobservable inputs (level 3) for the company as of December 31, 20X8.

Asset Categories	*Fair Value*	*Valuation Techniques*	*Unobservable Input*	*Input Value(s)*
			Broker quote	$345
Consumer nondurable goods	$3,280,000	Market comparable	Illiquidity adjustment (%)	(5)%
Indexed securities	2,100,000	Vendor pricing	Broker quote	105%

Sales of Equity Securities Investments

- Cost of securities sold and realized gain/loss are determined on either specific ID method or average cost method – <u>one method should be adopted and used for all.</u>
- Distributions from investment funds allocated pro rata portion of cost based on distribution/fair value
- Cost includes commissions and other charges that are part of the securities purchase transaction (currently.)
- Proceeds are net of transaction costs.
  - Different from fair value measurement rules
- Receivables for liquidating distributions

Proceeds Other Than From Sales

- Litigation proceeds relating to an investment security -
  - Accounted for under gain contingency provisions
  - If still holding security, proceeds are reduction of cost
  - If not holding security, proceeds are realized gain
- Securities received in a spin-off – (tax-free reorg)
  - Portion of cost of securities held allocated to securities received (ratio of FV rec’d to FV held)
  - No gain or loss for financial reporting purposes
- Tender offers –
  - When # of shares accepted is known, new value
  - Cost carries over to new shares

Accounting for Investment Income

- Dividends recorded at ex-dividend date
- Noncash dividends such as shares of different class, i.e. preferred shares -
  - Recorded at fair value of shares received
- Stock splits and stock dividends –
  - If of same class of stock, not income unless…
  - Choice to receive cash or stock
- Stock/Subscription rights received –
  - Allocated pro-rata portion of cost basis of related investment unless less than 15% of fair value
- Short dividends (on short positions) should be presented as an expense in the income statement

Investments in Foreign Equities

- Denominated and pay distributions in foreign currencies
- Exposes the investor to both –
  - Changes in market risks
  - Changes in currency exchange rates
- Realized and unrealized gains/losses –
  - Movement in market price AND movement in exchange rate
  - Two components may be combined for reporting or may be bifurcated
- Holdings at valuation date are translated at prevailing rates, resulting in unrealized foreign currency gain/loss.

Example of separate calculation of market and currency gain/loss

ABC Fund uses US$ as its functional currency.

ABC buys 1,000 shares of XYZ @ £15.00 with a spot exchange rate of $1.75 = £1.00.

Foreign currency (FC) cost basis	=	£15.00 × 1,000	=	£15,000
Functional currency cost basis	=	£15,000 × 1.75	=	$26,250

1,000 XYZ subsequently measured at fair value @ £16.00; spot rate: $1.85 = £1.00.

Market gain/loss	=	(FC current fair value – FC cost) X current FX rate		
Currency gain/loss	=	FC cost X (current FX rate – FX rate on day of purchase)		
Market gain	=	(£16,000 – £15,000) X 1.85	=	$1,850
Currency gain	=	£15,000 X (1.85 – 1.75)	=	$1,500
Total gain in functional currency				$3,350

Strafford

Key Concerns for Investment Company Reporting

- Recognition – trade date basis, transaction cost
- Valuation – mark-to-market at reporting dates (FV)
- Presentation – gains/losses recognized in earnings currently, gross vs. net presentation
- Disclosure – concentrations, liquidity, fair value measurement inputs

- Challenges for tax purposes –
  –
    – Acceleration of gains, deferral of losses
    – Maximize short-term treatment

Slide Intentionally Left Blank

Laura L. Ross, EisnerAmper
Elizabeth Powell, Decosimo

TAXATION OF INVESTMENTS IN SECURITIES

Section 1091-Wash Sales

- Mandates the deferral of losses on sales of stocks and securities when replacement securities are acquired within a specified time period.
- Purpose – to disallow losses to taxpayers when the taxpayer is in the same economic position before and after the loss transaction.

Section 1091-Wash Sales

- Mechanics of a wash sale:
  - If the taxpayer acquires substantially identical stock 30 days before or 30 days after the realization of a loss on a sale of stock or securities, the loss is disallowed and is a basis adjustment to the replacement lot.
  - Also applies to the acquisition of any contract to acquire (i.e. call options) substantially identical securities 30 days before or 30 days after a loss on stock or securities.
    - Reverse transaction is not a wash sale

Section 1091-Wash Sales

- Mechanics of a wash sale:
  - Holding period of lot sold at a loss tacks on to the holding period of the loss that absorbed the wash.
  - 30 days before and after are counted from trade date of the loss on a long security, not the settlement date.
  - Shorts closed out at a loss may need to start 30 day windows at settlement date, rather than trade date.
  - Losses are considered in the order securities are disposed of.

Section 1091-Wash Sales

- Mechanics of a wash sale:
  - Wash sale analysis is done on a share by share basis. Disproportionate lots will be prorated, and the shares will be matched up with the losses in order of acquisition.

Section 1091-Wash Sales

- Definition of Substantially Identical:
  - Not officially defined in Section 1091 – must rely on facts and circumstances.
  - Items to consider:
    - Deep-in-the-money puts
    - Bonds vs. Bonds
      - Attributes - mainly the security should have the same interest rate, face amount, and eligibilities in order to be considered substantially identical.
    - Single stock futures
    - Similar index funds

Section 1091-Wash Sales

- Definition of Substantially Identical:
  - Items to consider (con't):
    - Options
      - Likelihood of exercise
    - Options vs. Options
      - GCM 38285 – options on the same security bought after the closing of an option at a loss are identical if the have the same expiration date, even if they have different strikes.
    - Warrants

Section 1091-Wash Sales

Example 1:

On December 4, 2008, a calendar year taxpayer purchases 100 shares of IBM for $12,500. On December 30, 2008, the taxpayer sells the 100 shares of stock for $10,000 and therefore realizes a loss of $2,500. On January 2, 2009, the taxpayer decides to repurchase 100 shares of IBM at a total cost of $14,000.

Under the wash sale rule, the $2,500 loss will not be recognized for tax purpose in 2008, since within a 61 day time period (+- 30 days) from December 30, 2008 the taxpayer repurchased the stock.

Section 1091-Wash Sales

Example 2:

- October 1 – sell 100 shares of IBM at $2,000 loss
- October 15 – sell 100 shares of IBM at $5,000 loss
- October 20 – purchase 100 shares of IBM

The loss which will be disallowed is $2,000, realized by the sale made on October 1, which is the first loss disposed of that the repurchased lot could apply to.

Section 1091-Wash Sales

Current Issues:

- 2011 – Wash sale reporting required on 1099s.
- Form 8949 and related issues
  - Individuals
  - Partnerships
- Tax deferred accounts in relation to taxable accounts.

Slide Intentionally Left Blank

Section 1092-Straddles

- Section 1092 (c) (1) defines a straddle as an offsetting position created through the simultaneous ownership of actively traded personal property.
- Section 1092 (c) (2) states that an offsetting position is created if through the acquisition and simultaneous ownership of a position, the risk of loss is significantly reduced in another position also held by the taxpayer.

Section 1092-Straddles

Examples of offsetting positions:

- Long stock and a put, or writing a deep-in-the-money call option.
- Long and short on the same stock position (since 2004).
- Basket of stocks and an index option

Section 1092-Straddles

Consequences of creating a straddle:

- Loss deferral
- Suspension or termination of holding period
  - If position was held short term at time straddle was created, holding period is terminated.
  - If position was held long term at time straddle was created, holding period is suspended.
  - End result is you can’t change character of existing gain using a straddle technique.
- Interest expense incurred to hold positions in a straddle must be capitalized.

Section 1092-Straddles

Consequences of creating a straddle:

- Unlike a wash sale, a loss deferral related to a straddle is not a basis adjustment.
- Loss is deferred as long as there is a comparable amount of unrealized gain in the offsetting position that continues to be held.
- Losses can be realized if in future tax years the unrealized gain in the offsetting position decreases.

Section 1092-Straddles

Example:

- 100 shares of Cisco purchased on 5/1/08 at $22/share
- 100 shares of Cisco sold short on 8/18/08 at $25/share
- 100 shares of Cisco sold on 10/9/08 at $19/share
- At 12/31/08 the short position of 100 shares is still open and the fair market value of Cisco at 12/31/08 is $16/share
    - On 10/9/08 there was a realized loss of $3/share or $300. At year end there is an unrealized gain of $9/share or $900 on the short position. The $300 loss will be deferred for tax purposes because the unrealized gain on the short position is an offsetting position and the unrealized gain exceeds the realized loss.

Section 1092-Straddles

Example:

- 100 shares of IBM purchased on 2/1/08 at $100/share
- 1 put option for IBM at $120 purchased on 3/15/08 for $2,000
- The put option expires on 6/15/08. The fair market value of IBM is $125 on 6/15/08 therefore the taxpayer chooses not to exercise the option.
- At 12/31/08 IBM is priced at $130
    - On 6/15/08 when the option expired the taxpayer realized a loss of $2,000. At year end the unrealized gain on the long position is $30/share for a total of $3,000. The $2,000 realized loss on the option is deferred because an unrealized gain in excess of the unrealized loss exists on the offsetting position

Section 1233 - Short Sale Rules

What is a short sale? A short sale is a contract for sale of security that the seller does not own. The seller borrows the security from a broker and sells the security to a third party. The seller is liable to return the security to the broker.

Section 1233 was created to close out tax effects that were considered loopholes created by short sales. The areas affected are holding periods, character and timing of the recognition of gain or loss.

Section 1233 - Short Sale Rules

- Short sale rule 1: gain from closing a short sale is short-term capital gain even if the property used to close the short sale is a long-term asset in the hands of the taxpayer.

- Short sale rule 2: the holding period of substantially identical property, if such property was not held long-term at the time of the short sale, begins on the closing of a short sale.

- Short sale rule 3: any loss on closing a short sale is a long-term loss if substantially identical property has been held for the long-term holding period, even is the property delivered to close the short sale was held for less than the long-term holding period.

Section 1233 - Short Sale Rules

Example Rule 1:

- John borrows 100 shares of ABC stock from his broker and sells the stock for $50 per share on 2/1/2007. On 2/18/2008, John buys 100 shares of ABC stock at $30 per share. He pays $3,000 for the stock and returns the stock to the broker. The short sale is closed. John has made $2,000 from closing the short sale. The gain is short-term capital gain

Section 1233 - Short Sale Rules

Example Rule 2:

- John buys 100 shares of ABC stock for $70 per shares on 2/1/2008. John then borrows 100 shares of ABC stock from his broker and sells the stock for $90 per share on 3/1/2008. On 3/18/2008, John buys 100 shares of ABC stock at $75 per share. He pays $7,500 for the stock and returns the stock to the broker. The short sale is closed. John has made $1,500 from closing the short sale. The holding period for the originally 100 shares of ABC stock starts on 3/18/2008.

Worthless Short Securities

- Section 1233(h) – gain is recognized on a short position that becomes substantially worthless.

- No definition given for meaning of “substantially.”

Section 1259 - Constructive Sales

Effect:

- As previously discussed, the wash sale and straddle rules require taxpayers to defer losses in certain circumstances. Section 1259 takes the opposite approach and requires the taxpayer to accelerate gains during the tax year.
- The Taxpayer Relief Act of 1997 enacted Section 1259, which deals with constructive sales. Prior to the enactment of Section 1259 a taxpayer could lock in a gain by holding offsetting positions and defer taxes until disposition of the offsetting position.

Section 1259 - Constructive Sales

Section 1259(c)(1) states that a constructive sale has occurred in the following scenarios:

- Short against the box
- An offsetting notional principal contract is entered in respect to substantially identical property
- A forward or futures contract is entered to deliver substantially the same or identical property

Section 1259 - Constructive Sales

- Section 1259(a)(1) states that in the event of a constructive sale the taxpayer shall treat the financially appreciated position as if it were disposed of and the taxpayer must recognize gain on the financially appreciated position on the day the constructive sale occurred.

- The term substantially identical is a bit ambiguous, but the rules appear to be aimed at positions in which both the risk for gain and loss have been eliminated on the financially appreciated position.

Section 1259 - Constructive Sales

Example:

- 100 shares of stock X are purchased at $25/share on 3/13/08
- 100 shares of stock X are sold short at $35/share on 6/13/08
    - This is an example of a “short against the box”. The taxpayer has sold short shares of a stock which are also owned by the taxpayer. In this example the tax payer is holding substantially identical positions both long and short and the risk of gain or loss on the positions has been eliminated. The idea is that if the risk for gain or loss has been eliminated then the taxpayer should recognize the gain at that time, instead of when the financially appreciated position is disposed of.

Section 1259 - Constructive Sales

Example con't:

- 100 shares of stock X are purchased at $25/share on 3/13/08
- 100 shares of stock X are sold short at $35/share on 6/13/08
  - On 6/13/08, when the short position is opened, the long position that was opened on 3/13/08 is considered to be a constructive sale and the taxpayer will have a realized gain of $10/share or $1,000 for tax purposes in the current year. The long shares are considered to be sold and repurchased on the same date the offsetting short is opened.
  - Per Section 1259(a)(2)(b) the holding period on the long security is terminated upon entering the offsetting position and will not restart until theoffsetting position is disposed of. If the long position reached long term status when the box was created then the gain on the long position will be long term. Any losses suffered on the short position will be a long term loss.

Section 1259 - Constructive Sales

Unwinding-

Section 1259(c)(3)(A) allows for the taxpayer to avoid the recognition of constructive sales if certain conditions have been met.

- If the offsetting position is closed within 30 days after year end.
- The appreciated financial position must be held for 60 days after the offsetting position has been closed.
- During the 60 day period after the offsetting position is closed there can’t be a reduction in the risk of loss in regards to the appreciated financial position

If the three conditions have been met then the taxpayer will not be required to recognize constructive sales on offsetting positions held at year end.

Note – this didn’t eliminate the short sale rules.

Section 1256 Contracts

Under the Sec. 1256, a taxpayer is required to mark-to-market any 1256 contracts that were either closed during the year or open at year end. In addition to the mark-to-market rule, 1256 contracts are subject to the 60/40 rule. Under this rule, contracts are taxed 60% long-term and 40% short-term, without regards to the time period the contract was held

Section 1256 Contracts

- Instruments Subject to Section 1256:
  - Regulated futures contracts
    - Traded on QBOE
  - Foreign currency contracts
  - Non-equity options
    - Broad based index options
    - Commodities
    - Foreign currency
- Applies to both long and short positions

Section 1256 Contracts

- Treatment of Section 1256 Losses
  - Election available to carryback 1256 losses for three years to offset prior year 1256 gains.