

# ANCHIN<sup>®</sup>

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## Financial Services Group

# 2011 Year-End Tax Planning

*November 2011*



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## ***“Be informed, be flexible and be ready to act”***

The U.S. economy remains stagnant and the most recent news out of Washington is not good. The political wrangling continues and, while much is said, nothing has really been done to attempt to fix the problems and various inconsistencies that currently exist. Is Obama’s “tax the rich” plan the answer? What about Cain’s 9-9-9 plan? Or Perry’s flat tax plan? No matter what your thoughts are on these “options”, the bottom line is that while the country continues to face difficult economic times, solid financial and tax planning is needed now more than ever. The earlier that you focus on your tax situation and the available tax planning opportunities, the more likely you are to put yourself in a better tax position. The volatile securities markets as well as the uncertain political climate make year-end planning especially challenging. As year-end approaches, you should consider the following opportunities as you review your tax picture before year-end.

### **Mark-to-Market Election (§475(f))**

This election is available to traders in securities and should be considered and discussed where most of the buying and selling of securities by the taxpayer is short-term. The election converts all trading gains and losses (both realized and unrealized) to ordinary income or loss. Funds (or other taxpayers) that elect mark-to-market treatment are not subject to wash sales, straddles, constructive sales and other complex tax rules. However, the election, in general, eliminates the potential significant tax benefits of long-term capital gain treatment and the deferral of any unrealized gains.

**\*\*\* Caution & Reminder.** Once the mark-to-market election is made, it is binding for all subsequent years and cannot be revoked without the consent of the Internal Revenue Service.

- **Election for existing taxpayers – Prospective Election:** A statement must be filed no later than the due date (without regard to extensions) of the federal tax return for the tax year immediately preceding the election year and must be attached either to that tax return or the extension for that tax return. For example, if the election is to be effective for the 2012 tax year, the election would need to be made by April 15, 2012 (assuming the taxpayer is a calendar year taxpayer).
- **New Taxpayer Elections:** A statement should be documented in the taxpayer’s books and records within 2 months and 15 days of formation and a copy of the statement should be attached to the federal tax return for the year of the election. The statement must include the following: (1) that you are making an election under §475(f) of the Internal Revenue Code; (2) the first tax year for which the election is effective; (3) the trade or business for which you are making the election; (4) that the election only applies to securities and not to futures.

**\*Planning Opportunity.** If you have significant unrealized losses in your trading portfolio in 2011 (and you qualify as a trader and are therefore eligible to make the §475(f) election), you could benefit by continuing to hold those securities until the following year (or 2012). The taxpayer could then make the §475(f) election for 2012 and deduct the mark-to-market losses in 2012 as ordinary rather than selling the securities in 2011 and recognizing capital losses.

## **Short Sale Loss Planning**

If you plan to close a short sale at a loss in 2011 through the delivery of shares and you have to purchase those long shares, you need to have at least three business days for the settlement of the purchased shares in order to be able to deliver them to cover the short and deduct the capital loss in 2011. Therefore, if there are losses on short positions that you would like to recognize for tax purposes in 2011, and you need to buy the shares in the market to cover them, the purchases should take place with enough time for them to settle before year-end. Note that if the buy-to-cover positions are purchased too late in the year and settle in 2012, the short cover capital losses will be deferred until 2012.

**\* Planning Opportunity:** To avoid running afoul of this settlement issue, be sure to close out your short sales early enough in December if you wish to recognize the loss in 2011.

## **Wash Sale Planning Opportunities**

Never forget the impact these rules may have on your securities trading (especially at year-end when many are selling securities with unrealized losses in order to reduce taxable income). The wash sale rules disallow a loss sustained from the sale of stock or securities, if, within a 61-day period beginning 30-days before the sale, the taxpayer “acquires”, or enters into a contract or option to acquire, **substantially identical** stock or securities. In addition, a loss from closing a short sale is similarly disallowed where, within the restricted period, substantially identical stock or securities are sold or another short sale of identical stock or securities is entered into. These rules can be extremely complex, particularly for funds which actively trade. Some available trading strategies to plan around the wash sale rules are as follows:

- **Sell long stock at a loss and purchase a call option:** The taxpayer would (1) sell the stock and recognize the loss; (2) the next day, purchase a call option (an out-of-the-money call option will suffice) – which triggers the wash sale rules; (3) the following day, repurchase the stock and (4) sell (either later that day or the following morning) the call to recognize the loss.

Note that this last step (4) will not trigger the wash sale rule; not logical but it is the law. Therefore, the taxpayer in this example can buy back the shares in less than 31 days as long as they bought a call option on the same stock between the two transactions.

- **(Cover) short sale at a loss and purchase a put option:** Note that the wash sale rules will apply if the taxpayer (within the restricted period) executes another short sale with respect to substantially identical stock or securities. The wash sale rules in this respect (cover a short and buy a put option) are anything but clear with many practitioners believing this is a wash sale while others believe that it is not.

Therefore, a cautionary best practice would be to employ a strategy similar to the “Purchase of a Call Option strategy” discussed above where the taxpayer would (1) cover the short and recognize the loss; (2) the next day, purchase a put option – which (we believe) triggers the wash sale rules; (3) the following day, re-short the stock and (4) sell (either later that day or the following morning) the put to recognize the loss. Note that this last step (4) will not trigger the wash sale rules since the selling of a put at a loss will only be deemed a wash sale if the taxpayer buys another put with the same expiration date as the previously disposed of put within the restricted period.

- **Sell long stock at a loss and sell a put option (or “write a put”):** Where a taxpayer sells a long stock at a loss but seeks to remain economically at risk with respect to the stock, the wash sale rules seem to present an obstacle. Not only is the taxpayer barred from reacquiring the stock during the restricted period, the law also forbids the acquisition of a call option within this same period.

A large degree of exposure can be permissibly attained if the taxpayer, within the restricted period, sells (writes) a put option; a transaction not covered by the current wash sale rules.

**Caution:** Some care needs to be exercised in writing the put as IRS guidance states that if a taxpayer sells stock at a loss and within the restricted period sells a put option, the sale of the put option “*may*” trigger the wash sale rules. The IRS guidance appears to allow the sale of puts only if they are “not likely to be exercised”. Given that there are no clear guidelines for this “not likely to be exercised” standard, most practitioners advise the writing of puts that are either at-the-money or out-of-the-money.

- **Sell stock at a loss and enter into a basket swap:** In this scenario, the taxpayer holds stock with a market value that is lower than the tax basis of the stock and seeks to deduct a capital loss on the sale of the stock while still maintaining economic exposure with respect to the disposed of stock. The following transaction may allow the taxpayer to maintain economic exposure to the stock and to deduct a capital loss without disallowance under the wash sale rules.

In a proposed transaction, the taxpayer sells (at a loss) the stock in the open market and simultaneously enters into a swap agreement with counterparty with respect to a **basket** of securities that includes the sold stock. The swap will terminate on the 35<sup>th</sup> day following the date on which the swap is entered into (the “Maturity Date”). The swap will provide that on the Maturity Date, (1) the taxpayer will pay the counterparty an amount equal to the depreciation in the value of the basket over the term of the swap and (2) the counterparty will pay the taxpayer an amount equal to the appreciation in the value of the basket over such term. In addition, the swap will provide that the counterparty will pay to the taxpayer an amount equal to dividends paid during the term of the swap on stocks that comprise the basket. The taxpayer also will make LIBOR-based payments to the counterparty determined with reference to the initial value of the stocks comprising the basket on a weekly basis over the term of the swap.

The basket should be comprised of 20 or more stocks of unrelated issuers, including the stock(s) sold. On the date the swap is entered into the fair market value of the stock(s) sold should represent less than 70% of the fair market value of all the stocks comprising the basket. We believe that such a basket will not be deemed substantially identical to the shares sold.

- **Purposely trigger the wash sale rules and postpone loss recognition:** Assume that you sold stock in 2011 at a loss and then realize that the loss is going to offset long-term capital gains (currently taxed at preferentially lower tax rates) – you want to postpone recognizing the loss until 2012. If the loss is within the restricted period, simply repurchase the shares so that the loss gets deferred under the wash sale rules; the loss will then get included in the basis of the newly repurchased shares and is not currently recognized.

- **Purposely trigger the wash sale rules and tacked on holding period:** Stock that has fallen in value is often sold before attaining long-term holding status in order to benefit from short term capital loss treatment. If you notice that the stock price has risen shortly after a sale at a loss, you can repurchase the stock within the restricted period, and the holding period you had attained on the previously sold shares will be “tacked” on to the holding period of the newly acquired shares. As a result, if you then find yourself with an overall gain on the repurchased shares, you can take advantage of the long-term capital gains rate (assuming the combined holding period of the two lots of stock exceeds one year).

### **Examine Portfolio for “Worthless Security” Positions**

A capital loss is only available in the year a security position becomes totally worthless or is abandoned. The concept of worthlessness is based on facts and circumstances and could have many interpretations. A taxpayer generally must establish that the security position had a basis, was not worthless before the year he or she claimed worthlessness and was worthless in the year claimed. One must demonstrate both balance sheet insolvency and a complete lack of future potential value. Balance sheet insolvency entails proving that liabilities exceed assets in the year of worthlessness. Even though the balance sheet may show insolvency, the stock of the corporation could possibly have some value in the future. Therefore, the taxpayer must also demonstrate the destruction of potential future value to establish current worthlessness.

\* **Planning Opportunity:** In many cases, where facts are not available and future potential value is not clear, many taxpayers sell the security position to an unrelated third party, for a nominal amount, in order to guarantee a definite capital loss and definite year of deductibility.

### **Abandoning a Partnership Interest**

The economic environment has deteriorated the value of many investments, including partnership interests that do not offer any reasonable prospect of a return. A partner may own a partnership interest that becomes worthless (or nearly worthless) and these may be worth a second look before the end of this year. These partnerships may have little economic value but could produce a significant tax benefit for investors. To the extent a partner has remaining adjusted (tax) basis in the partnership interest, the IRS has ruled that a loss incurred in the abandonment or worthlessness of a partnership interest is ordinary if there is no sale or exchange. However, to the extent the partner receives any consideration for the partnership interest in the form of monies or relief from liabilities, the abandonment or worthlessness will be treated as a sale or exchange subject to capital loss treatment.

If a partner determines that abandonment is the best option, there are only a few steps that must be completed within the current tax year. The IRS has made clear that the abandonment of a partnership interest should be accompanied by the partner’s notification of their intent and further documentation that all future rights have been abandoned. The abandonment of a partnership interest is complex and many facts need to be considered. In determining whether taxpayers have taken sufficient actions so as to abandon their interests, courts have noted facts such as a taxpayer having no further dealings with the abandoned partnership, no expectation to receive anything and not actually receiving anything further in later years.

\*\* **Reminder:** It is a good idea to check the partnership operating agreement to see whether it has a process for giving up the interest and withdrawing from the partnership. If not, a letter to the general partner stating the wish to abandon the interest in the partnership, the intent to have no further dealings with the partnership and that there is no expectation of further benefits from the partnership is a good way to establish abandonment.

\*\* **Caution:** Confirm that state law does not impose any additional requirements upon withdrawing or exiting partners.

## **Cash Distributions – Don't Forget Your Tax Basis!**

Requesting a full or partial redemption from a partnership investment may produce unwanted results if you do not consider your tax basis in the partnership. Although the GAAP basis capital account may show significant value that does not necessarily mean that the distributions will be tax free. The difference between the economic capital and your tax basis in the investment is generally your allocated unrealized gain or loss on investments of the partnership. Generally partial redemptions from a partnership are tax free to the extent the cash and property received does not exceed your tax basis in the partnership interest while a full redemption from a partnership will be a taxable event unless property is received as part of the redemption.

**\*\* Caution & Reminder:** If the tax basis of the partnership is higher than the economic basis a partial redemption will not create a tax loss for the current year. Losses are only deductible on a complete termination of the partnership interest in exchange for cash.

## **2011 Deferral Election Deadline – Grandfathered Plans**

Section 457A of the Internal Revenue Code generally prevented the deferral of incentive or management fees earned after 2008. However, pre-2009 deferrals which were grandfathered from the application of this rule but must be included in income in a tax year prior to 2018. Grandfathered deferrals that will be taxed in 2017 (even if payable in a later year) could present taxpayers with cash flow problems since §409A does not allow acceleration of the payment of deferrals. Deferrals that are due to be taxed in 2017 (under §457A) may be accelerated to be paid in 2017 provided that the acceleration is “documented and binding” no later than December 31, 2011. Therefore, if you have any deferrals due after December 31, 2017, please contact your tax and legal advisor as you may need to act by December 31, 2011.

## **Carried Interest – Lost, but not forgotten?**

After lying dormant for most of the year, the potential taxation of carried interest is back in the news. In September of 2011, the Obama administration submitted statutory language for the proposed American Jobs Act to Congress. The proposal contains a number of revenue offsets, including an updated proposal to tax carried interest as ordinary income. While the new proposal made some significant changes when compared to earlier versions, the impact and original basis for the earlier proposals still remain intact. The proposed legislation would generally be effective for taxable years ending after December 31, 2012. However, in this current political climate, the outcome and timing is as unpredictable as it ever was so we will not venture a guess as to timing or the possibility of this becoming law.

As with any proposed changes, there can be opportunities to minimize and possibly eliminate the impact of those provisions with proper planning or restructuring between now and the proposed effective date. While the legislation has not yet passed, you should consider some of the following now:

- Distributions of appreciated positions.
- Deferral of general partner distributions and acceleration of general partner contributions in order to increase “qualified capital”.
- Accelerating capital gains while deferring capital losses (or purposely failing wash sale rules).

## **Enhanced Depreciation Opportunities**

For many business (i.e., management companies), a potential 2011 tax-saving opportunity may be increased depreciation deductions that are set to become less favorable in 2012.

- **100% Bonus Depreciation** - for qualified property placed in service by December 31, 2011. Qualified property includes new tangible property with a recovery period of 20 years or less and off-the-shelf computer software. For 2012, bonus depreciation is scheduled to drop to 50%. Therefore, you may want to consider purchasing (and placing in service) qualifying assets by December 31, 2011 not only to reduce your 2011 taxable income but also to take advantage of the 100% bonus depreciation deduction – in case it is not extended.

**\* Planning Opportunity:** Companies that have recently moved offices or have made significant improvements may be entitled to larger depreciation deductions for qualified improvements. A **Cost-Segregation study** should be considered in order to properly identify qualified leasehold improvements eligible for bonus depreciation or a lower depreciable life. Anchin is capable of performing the required study.

- **Section 179 expensing** – for 2011, allows a deduction of \$500,000 which phases out as the cost of the property placed in service exceeds \$2,000,000. For 2012, the deduction and phase out are scheduled to drop to \$125,000 and \$500,000, respectively. Note that this election does not allow you to reduce income below zero.

**\*\* Caution & Reminder:** While both bonus depreciation and section 179 expensing are excellent opportunities to reduce current year taxable income, the more difficult analysis will be to determine whether the larger 2011 deductions could be better utilized in the future (when tax rates are expected to increase). Taking these enhanced (and higher) deductions now means lower depreciation deductions in future years.

## **Estate Planning Considerations**

While estate planning will not affect your current income tax bill, it is a good idea to consider some techniques in light of the current environment and potential tax law changes that lie ahead. As you may recall, in late 2010, Congress passed legislation which included a very significant change affecting estate planning: an increase from \$1 million to \$5 million in the lifetime gift tax exemption (\$2 million to \$10 million for married couples).

The \$5 million lifetime gift tax exemption is scheduled to be in effect only through December 31, 2012 and unless Congress enacts legislation stating otherwise, the exemption will fall back to \$1 million. Therefore, there appears to be a once in a lifetime opportunity to move substantial wealth out of taxable estates (at no Federal gift tax cost) and may protect those transfers as well from generation-skipping transfer tax (GST exemption was also increased until December 31, 2012 from \$3.5 million to \$5 million).

However, as with most good things, potential change is in the air. While “Super Committee” was unable to come to an agreement by its November 23, 2011 deadline, their deliberations included changes in the current estate, gift and generation-skipping transfer tax laws. Rumor had it that the Federal gift tax exemption could have been reduced from the current \$5 million to \$1 million – possibly as soon as December 31, 2011 or sooner. Congress may consider some of these proposals as they move forward. Since we long ago put away our crystal ball, you may want to consider making use of your gift tax exemptions as soon as possible. A few other estate planning techniques you may want to consider are as follows:

- **Grantor Retained Annuity Trusts (GRATs)** - provides you with a fixed annual amount (an “annuity”) from the trust for a term of years (as short as two years under current law). The annuity retained may be equal to 100% of the amount that you use to fund the GRAT, plus the IRS-sanctioned rate of return applicable to GRATs (which for transfers made in December 2011 is less than 2.0%). Note that as long as the GRAT assets outperform 2.0%, at the end of the annuity term you will be able to achieve a tax-free gift of the spread between the actual growth of the assets and 2.0%. Because you will retain the full value of the GRAT assets at the end of the trust’s term, if you survive the annuity term, the value of the GRAT assets in excess of your retained annuity amount will then pass to the beneficiaries with no gift or estate tax, either outright or in an additional trust vehicle.

**\*\*\* Caution:** If the grantor dies during the term of the GRAT, the entire balance will revert to the grantor as if the (GRAT) transaction never took place. In addition, if the value of the GRAT assets fall below the amount required for the requisite annuity payments, the GRAT collapses as if the (GRAT) transaction never took place.

**\* Planning opportunity:** Note that the amount of principal not received as part of an annuity payment will be subject to a current gift tax. Since the amount is not considered a present interest (meaning beneficiaries do not have immediate use of the money) the amount will not be eligible for the annual gifting exclusion. Why not use a “zeroed-out GRAT” - structured so that the value of the gift transferred to the beneficiary is zero?

**\* Planning opportunity:** Instead of setting up one GRAT to house all transferred assets, why not set up multiple GRATs to house different assets types – some conservatively invested and others with more risk? The winners, or appreciated GRATs, do their job of transferring wealth to the next generation; the losers collapse, as if the GRAT for these assets never took place. In the end, all GRATs should have an economic purpose and have some risk exposure. Also, varying the beneficiaries and trust start dates may be advisable.

There have been a number of proposals, including one debated by the Super Committee – to require that GRATs have a minimum term of 10 years. As discussed above, there are certain benefits associated with shorter-term GRATs. Therefore, because of the possibility that legislation may soon pass, those who are contemplating this terrific opportunity to transfer wealth, should do so as soon as possible.

- **Low Interest Loans or Intra-Family Loans** – is a simple and effective estate planning mechanism for transferring wealth to children or grandchildren without gift tax. Since interest rates are currently at all-time lows, you may wish to consider making such loans to family members or to trusts set up on their behalf. Note that when you make a loan to a family member, you must charge interest in order to avoid making a gift. Therefore, to the extent that the family member earns a higher rate of return on the borrowed funds than the very low interest rate being paid, the excess or difference is transferred free of gift taxes.

## **Charitable Contributions – What about Securities?**

If you are contemplating making charitable contributions before year end, the most tax-efficient way to do this is to give appreciated publicly traded stock that has been held for more than a year. Doing so, donors receive a charitable contribution deduction equal to the fair market value of the securities contributed and escape paying tax on their built-in appreciation. Also, the donation of appreciated, publicly traded securities does not require you to get a qualified appraisal to establish the value of your deduction. Note that this is a much better result than selling the stock, paying a capital gains tax, and then deciding to use the proceeds to make cash contributions to charity.

**\*\*\* Caution & Reminder.** Do not donate depreciated securities to charity. If this is the case, sell the securities first and then donate the proceeds to charity so that you can take the capital loss on the sale and get a charitable deduction for the donated cash.

**\*\*\* Caution & Reminder.** If you are planning on donating a non-publicly traded stock to a charity, you are **required** to get a qualified appraisal to establish its value. Otherwise, you will only be entitled to a charitable deduction equal to your basis in the stock.

**\*\*\* Caution & Reminder.** The value of a donation of publicly traded securities held for a year or less is limited to the donor's cost basis.

**\* Planning opportunities:** Consider a partial (non-liquidating) distribution from investment partnership interests consisting of appreciated securities in order to then make charitable contributions.

**\*\* Note:** Donations can be made to public charities, private foundations, and donor advised funds. The use of a donor advised fund provides the donor with a current charitable deduction without having to decide immediately which specific charity gets the contributions. Anchin has established the Park Avenue Charitable Fund to assist individuals with their charitable giving needs and requirements.

### **Holding Period of Capital Assets – A Refresher**

The holding period begins on the day after the acquisition date and ends with the date of sale. The dates on which securities are traded control, not the settlement dates. There are numerous transactions that will either terminate or suspend the holding period of a capital asset. These are summarized in the following table:

<u>Long Position Held</u>	<u>Offsetting Transaction</u> <sup>(1)</sup>	<u>Effect on Holding Period</u>
Short-term	(a) Short the stock	Terminated <sup>(2)</sup>
	(b) Buy put option	Terminated <sup>(2)</sup>
	(c) Sell deep-in-the money call option <sup>(5)</sup>	Terminated <sup>(2)</sup>
Long-term	(a) Short the stock	No effect <sup>(6)</sup>
	(b) Buy put option	No effect
	(c) Sell deep-in-the money call option <sup>(5)</sup>	No effect
Short or long term	Sell qualified call not in-the-money <sup>(3)</sup>	No effect
Short or long term	Sell qualified call in-the-money <sup>(3)</sup>	Suspended <sup>(4)</sup>

#### **Notes:**

- (1) The effect of an offsetting transaction described above only applies to the extent of an equal amount of shares held long.
- (2) The holding period of the long position terminates on the date of the specified transaction. A new holding period of the long position begins on the date the offsetting instrument expires or is sold.
- (3) A qualified covered call must meet the following criteria: exchange traded, term of more than 30 days, not an ordinary income or loss asset, and not “deep-in-the-money.”
- (4) The holding period of the long position is merely suspended on the date of the specified transaction. The holding period begins to toll again once the offsetting instrument expires or is sold. There is a tack on of the holding period - the new holding period includes the old holding period.
- (5) A deep-in-the money call option is generally where the call price is significantly less than the current market price of the underlying stock.
- (6) A loss on the short position should be reclassified to long-term.

**Constructive Sale Rules and Reminder**

Prior to the enactment of §1259 of the Internal Revenue Code by the Taxpayer Relief Act of 1997, taxpayers could lock in gains on appreciated financial positions, without the immediate recognition of income, by using such hedging strategies as short sales against the box. Effective for transactions entered into after June 8, 1997 such a transaction is deemed to be a constructive sale and the taxpayer must recognize gains (not losses) as if the position was sold, assigned or otherwise terminated at its fair market value.

*For example, assume a taxpayer holds a long (appreciated) security position. On July 1, 2011 the taxpayer shorted the same security (“short against the box”). If the transaction is a constructive sale, the gain is deemed to have arisen on July 1st and is taxable in 2011 even though the taxpayer has not sold a position and is still holding both the long and short position at December 31st. If the transaction is unwound utilizing the “short term hedging exception” described below, then the gain is not taxable in 2011.*

A short against the box will **not** be considered a constructive sale provided:

1. the offsetting position (in our example above, the short sale) is closed within 30 days after the year-end and,
2. the appreciated long position is held “naked” for an additional 60 days (after the short offsetting position is closed).

**Note:** In order to avoid the constructive sale rules both tests must be met. **Caution:** The closing of a short sale requires delivery. Accordingly, the short sale must be delivered or settled, and not just sold by January 30<sup>th</sup> of the succeeding year. When a short sale occurs in 2011, against an appreciated long position -- the following table illustrates the tax result:

Transaction	Amount Taxable	Year Taxable
Short closed by delivery of long position in 2011	Net appreciation at date of delivery	2011
Short closed by purchase in market in 2011, and  long position held for an additional 60 days	Gain or loss on closing of short position  Gain or loss on long position is deferred	2011  Date of disposition of long position
Short closed by delivery of long position by January 30, 2012	Gain on long position at date of short sale	2011
Short closed by purchase in market to settle by January 30, 2012, and long position held “naked” for at least 60 additional days	Gain or loss on closing of short position  Gain or loss on closing of long position	2012  Date of disposition of long position
Both long and short positions still in place post January 30, 2012	Appreciation on long position at date of short sale	2011

The items and planning opportunities discussed in this guide are general in nature and may not apply the same to each taxpayer's situation. If you would like to discuss any of these techniques or planning ideas, please contact your engagement partner or any partner of **Anchin's Financial Services Group** at your earliest convenience. We stand ready as **Your Expert Partner** to help you plan effectively and to navigate through the various tax rules that may apply to you and your fund.

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