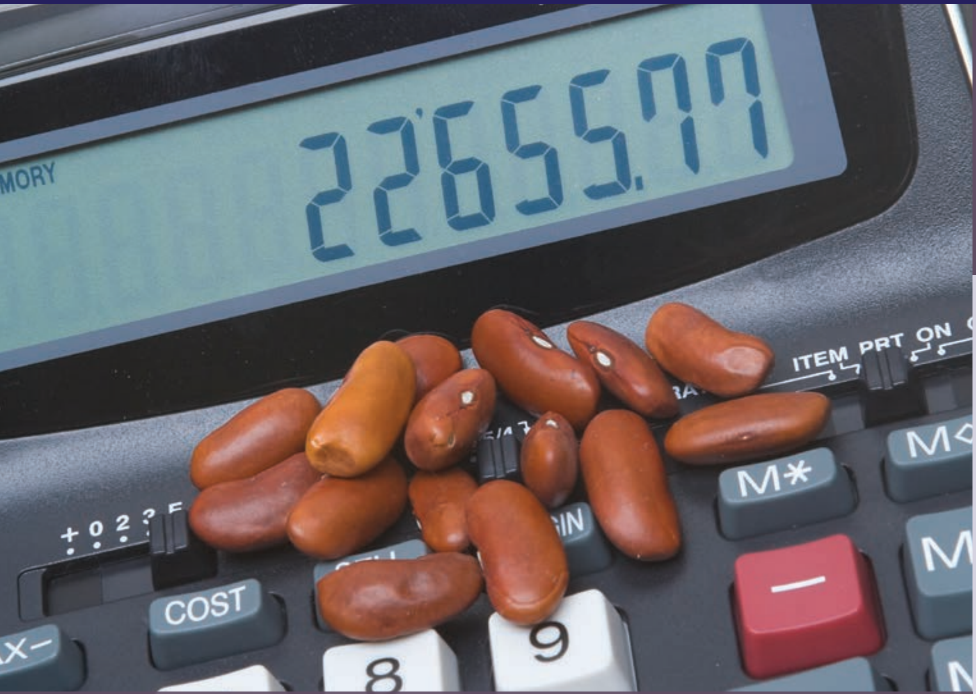
MANAGEMENT & *TAX CONCEPTS*

WINTER 2017



CASH VS. ACCRUAL ACCOUNTING: DIFFERENT WAYS TO COUNT YOUR BEANS

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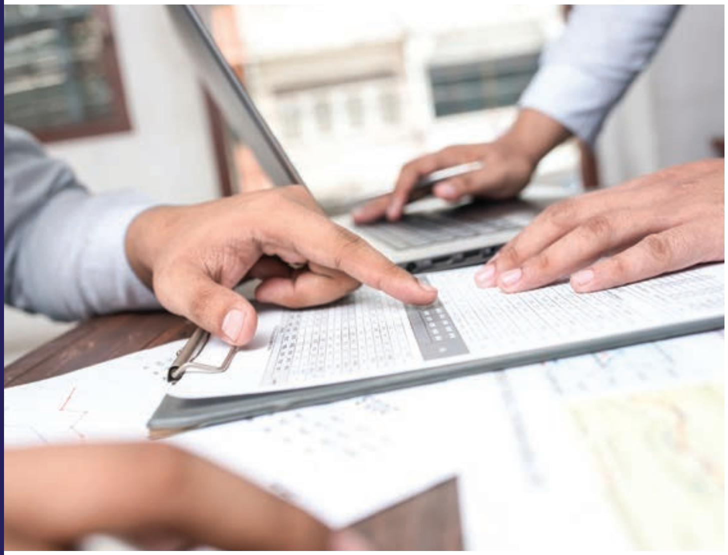
Cash vs. accrual accounting: Different ways to count your beans

There are two accounting methods used by businesses to keep track of income and expenses, and it's critical to understand the differences between the two.

Cash-basis accounting is the simpler method. It's generally available to businesses with no more than $10 million in annual sales and to professional services firms of any size. There is a lower $5 million threshold for C corps, and for partnerships in which a C corp is a partner. *Accrual-basis* accounting generally must be used by nonprofessional services firms with annual sales of more than $10 million. An exception to this general rule: Certain businesses with inventory are required to use the accrual basis for the purchases and sales of merchandise if annual sales exceed $1,000,000.



THE DIFFERENCES

The cash-basis and accrual-basis methods of accounting differ primarily in the timing of when transactions are credited and debited to accounts. With cash-basis accounting, revenue is recognized when payment of invoices is received, and expenses are recognized when they're paid.

With accrual-basis accounting, revenue is recognized when it's earned, and expenses are recognized when they're incurred. Accrual-basis accounting conforms to the matching principle under Generally Accepted Accounting Principles. In other words, revenue and expenses are matched to the time periods when they're actually earned or incurred.

For example, ABC Consulting finished an engagement in December and invoiced the client $10,000 upon completion of the job. It received a check for payment in January. Using cash-basis accounting, income of $10,000 is recorded in January.

In addition, ABC Consulting purchased several new office computers in December for $5,000. The seller offered 30 days "same as cash" financing, so ABC didn't pay for these computers until January. Using cash-basis accounting, it would record the $5,000 expense in January, not December. By contrast, if ABC used a credit card to make the purchase, it would record the purchase in December.

Now consider XYZ Manufacturing Co., which sold a piece of machinery to a client for $10,000 in

Is Congress targeting cash accounting?

In recent years, Congress has floated proposals to limit the use of cash-basis accounting among certain types of businesses.

This would enable the federal government to collect tax revenue sooner. The Joint Committee on Taxation scored one such proposal and determined that forcing some types of professional services firms to switch from cash-basis to accrual-basis accounting would raise federal revenue.

One proposal would have required almost all service companies with annual gross receipts greater than $10 million to switch from cash to accrual accounting. This would have affected service businesses in a wide range of industries, including legal, architecture, engineering, health care, accounting and consulting.

None of the proposals has made it to the floor of Congress for a vote. But with a new administration about to be sworn in and a new Congress about to be seated, there's the possibility that a proposal like this could be reintroduced.

The American Institute of Certified Public Accountants (AICPA) and American Bar Association have voiced strong opposition to requiring professional services businesses, including CPA firms and law firms, to use the accrual method of accounting. "We strongly urge you to reconsider limiting the use of the cash method of accounting," stated the AICPA's president in a recent letter.

December but didn't receive a check for payment until January. Using accrual-basis accounting, the company would record the $10,000 as revenue in December instead of waiting until January.

XYZ also bought $5,000 worth of office equipment in December on credit and paid for it in January. Using accrual-basis accounting, this $5,000 expense would be recorded in its books in December, when it took possession of the office equipment.

INCOME AND EXPENSE TIMING

Potential tax ramifications are key factors to consider when deciding which accounting method to use. The main factor involves the timing of income and expenses at the end of the year.

Businesses that use cash-basis accounting are able to take advantage of a popular year-end tax planning strategy in which revenue recognition is postponed until January and business expenses are accelerated into December. This can be done by not invoicing work completed in December until early January, and buying and paying for deductible assets in December instead of waiting until January.

This may lower your current taxes by deferring taxable income into the next year while accelerating deductible expenses into the current year. However, this strategy typically isn't as easily available to businesses that use accrual-basis accounting.

IS SIMPLICITY WORTH IT?

Because of its simplicity, many small businesses use cash-basis accounting for as long as they can — until they reach the IRS thresholds previously discussed. But there are some potential drawbacks.

For example, companies that use cash-basis accounting sometimes report large fluctuations in profits from one period to the next due to the timing of payment receipts. This can make it hard to get an accurate picture of long-term profitability. It also makes it tough to benchmark performance from one year to the next and against similar businesses that use accrual-basis accounting.

Be sure to talk to your accounting professional for more guidance in determining the right accounting method for your business. •

Paying for LTC insurance with your life insurance policy

At least 70% of people over the age of 65 will require some level of long-term care service, according to insurance company Genworth Financial's *2016 Cost of Care Survey*. And that care can be very expensive. For example, on average per month, it costs $3,628 for care in an assisted-living facility, $3,861 for a home health aide and $7,698 for a private room in a nursing home, according to Genworth. So, you wonder, how are you going to pay for this without exhausting your savings?

Long-term care (LTC) insurance can be an effective way to protect your nest egg against these expenses and preserve it for the next generation, but premiums for these policies can be expensive. Here's where your life insurance policy could enter in. A tax-free exchange using your life insurance policy can be a cost-efficient strategy for funding LTC premiums.

PARTIAL OR FULL EXCHANGES ALLOWED

Historically, the IRS permitted taxpayers to exchange certain policy types without a tax cost: one life insurance policy for another, one annuity contract for another, or a life insurance policy for an annuity contract. Notably, the exchange of an annuity contract for a life insurance policy wasn't granted favorable tax status.

The rule later was expanded to allow *partial* tax-free exchanges and, more recently, LTC contracts were added to the permissible list. So, it's now possible to make a total or partial tax-free exchange of a life insurance policy or annuity contract for an LTC policy — as well as one LTC policy for another. But there are some restrictions. For example, to avoid negative tax consequences after making a partial exchange of an annuity contract for an LTC policy, you must wait at least 180 days before taking any distributions from the annuity.

TAX BENEFITS ARE SIGNIFICANT

A tax-free exchange provides a source of funds for LTC coverage and offers significant tax benefits. Ordinarily, if the value of a life insurance policy or annuity contract exceeds your basis, lifetime distributions include a combination of taxable gain and nontaxable return of basis. A tax-free exchange allows you to defer taxable gain and, to the extent the gain is absorbed by LTC insurance premiums, eliminate it permanently. Consider this example:

Joan, age 72, is concerned about possible LTC expenses and plans to buy an LTC insurance policy with a premium of $10,000 per year. She owns a nonqualified annuity (that is, an annuity that's not part of a qualified retirement plan) with a value of $250,000 and a basis of $150,000, and Joan wishes to use a portion of the annuity funds to pay the LTC premiums. Under the annuity tax rules, withdrawals are treated as "income first." In other words, the first $100,000 she withdraws will be fully taxable and then any additional withdrawals will be treated as a nontaxable return of basis.

To avoid a taxable gain, Joan uses partial tax-free exchanges to fund the $10,000 annual premium payments. In an exchange, each distribution includes taxable gain and basis in the same proportions as the annuity: In this case, the gain is ($100,000/$250,000) × $10,000 = $4,000. Thus, each partial exchange used to pay LTC premiums permanently eliminates $4,000 in taxable gain.

Partial tax-free exchanges can work well for stand-alone LTC policies, which generally require annual premium payments and prohibit prepayment. Another option is a policy that combines the benefits of LTC coverage with the benefits of a life insurance policy or an annuity.

Typically, with these "combo policies," the death or annuity benefits are reduced to the extent the policy pays for LTC expenses.

PLAN YOUR FUTURE

Financing an LTC health plan with your life insurance policy might be a smart addition to your estate plan. Talk to your CPA about whether this option makes sense for you. •

Business planning

It's time to get moving on your 2017 goals

If you haven't yet created a business plan for 2017, it's not too late to catch the proverbial worm. The start of a new year is a great time to meet with your management team and analyze how your company performed in 2016 relative to the goals and objectives set forth in your 2016 plan. Based on this analysis, you can then set new goals and objectives for 2017.

START WITH YOUR FINANCIALS

There are several areas of your business to examine as you review last year's performance and make plans for 2017. The first and most important area is usually the financials. In particular, take a close look at the following key performance indicators, or KPIs:

Gross profit. This figure will tell you how much money you made after your manufacturing and selling costs were paid. It's calculated by subtracting the cost of goods sold from your total revenue.

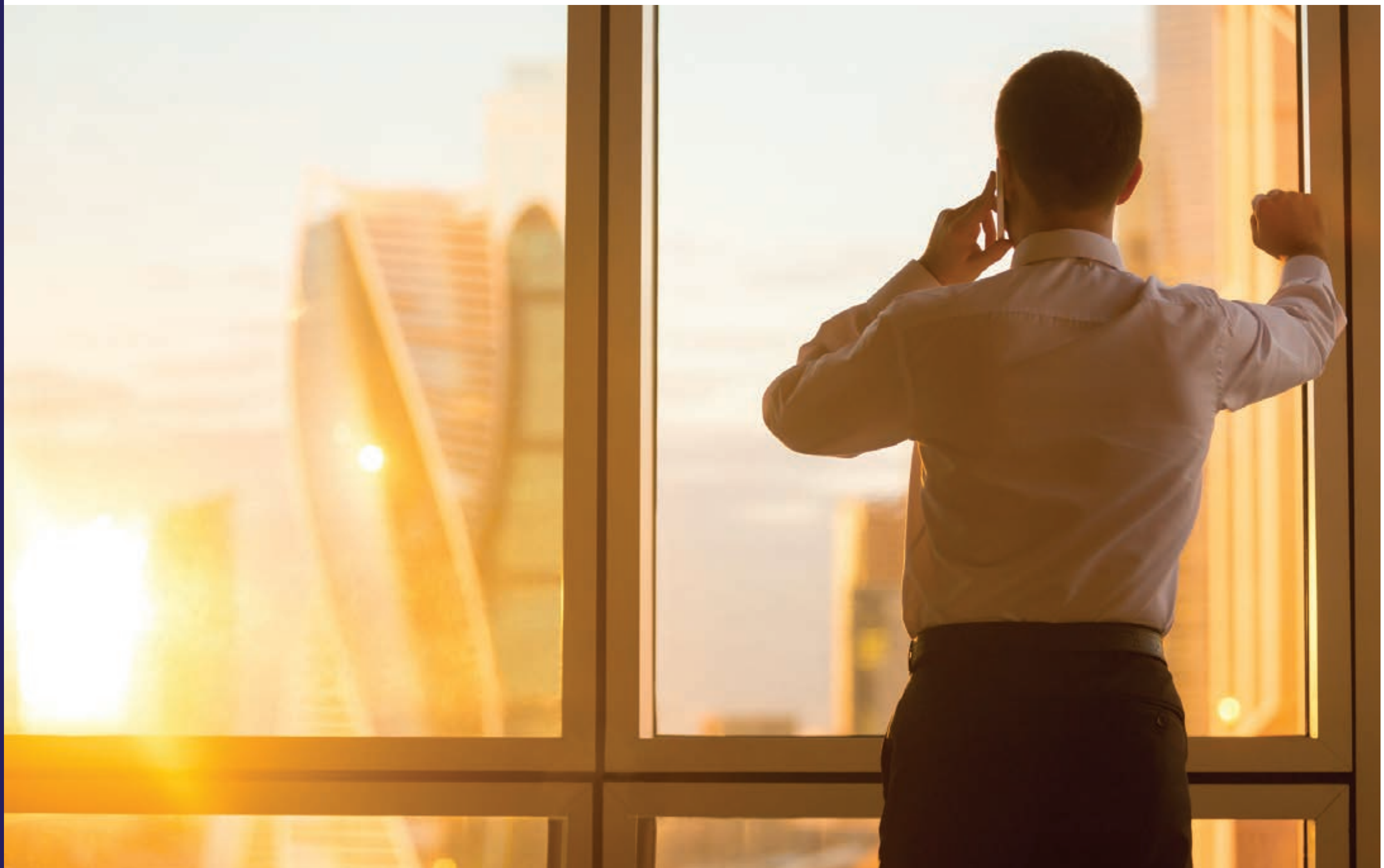
Current ratio. This ratio will help you gauge the strength of your cash flow. It's calculated by dividing your current assets by your current liabilities.

Inventory turnover ratio. This ratio will warn you ahead of time if certain items are moving more slowly than they have in the past. It also will tell you how often these items are turned over. The ratio is calculated by dividing your cost of goods sold by your average inventory for the period.

Debt-to-equity ratio. This ratio will measure your company's leverage, or how much debt is being used to finance your assets. It's calculated by dividing your total liabilities by shareholder's equity.

OTHER AREAS TO EXAMINE

Human resources is another critical area to examine in your business planning. For example, what



was your employee turnover rate last year? High employee turnover could be a sign of underlying problems, such as poor training and management, workers who are mismatched with jobs, and low employee morale.

Sales and marketing also is worth a close examination. Did you meet your goals for new sales last year, as measured in both sales volume and number of new customers? Did you generate an adequate return on investment (ROI) for your marketing dollars? If you can't answer this last question, implement procedures for tracking the results of *future* marketing efforts so you can gauge marketing ROI going forward.

Finally, take a close look at your production and operations. If yours is a manufacturing business, what was your unit reject rate? Or if yours is a service business, how satisfied are your customers with the level of service your employees provided? Again, you may need to implement procedures for gauging customer satisfaction to answer this question this time next year.

A SET OF NEW OBJECTIVES

With a review of last year's performance complete, you can now set new goals in each of these areas for 2017. On the financial side, for instance, your goal might be to boost your gross profit from 20% to 30%. How will you lower your costs or increase efficiency to make this goal a reality?

Or maybe you want to lower your employee turnover rate from 20% to 10%. What will you do differently from a training and management standpoint to keep your employees from jumping ship this year?

DON'T WAIT ANY LONGER

Don't let the start of a new year pass without reviewing your business's recent performance. Then use this data to set realistic goals for the coming year. •

Beware of the "kiddie tax" trap

Making gifts to children and grandchildren is a strategy sometimes used to reduce taxes. Doing so may shift some of your income into a lower tax bracket and remove assets from your taxable estate. But if you employ this strategy, beware of a hidden tax sometimes called the "kiddie tax."

The kiddie tax isn't a separate tax. Rather, it's an income threshold above which a minor's unearned income (interest, dividends and capital gains) is taxed at his or her parent's marginal tax rate instead of the child's rate.

WHO'S A "KIDDIE"?

For kiddie tax purposes, a child is anyone under age 19 or any full-time college student under age 24. Previously, the kiddie tax applied only to children under age 14. But Congress increased the age limit to make it harder for parents and grandparents to reduce taxes by shifting income.

The first $1,050 of a child's unearned income is tax-free and the next $1,050 is taxed at the child's marginal rate. All unearned income above $2,100 is then taxed at the parent's marginal rate, which could be as high as 39.6%.

Let's assume you own stock that has appreciated by $10,000 and want to give this to your 16-year-old son. Assuming your son doesn't have any other unearned income, only $2,100 of the taxable gain would be taxed at his marginal rate. The remaining $7,900 would be taxed at your marginal rate.

ARE THERE STRATEGIES TO AVOID THE TAX?

There's a possible way to skirt the kiddie tax, particularly if your child or grandchild is in college. If he or she earns income via a wage or salary that provides more than half of his or her support, he or she might not be treated as a dependent. Further, there may be some additional income tax benefits related to tuition, because your child may be able to claim a deduction or credit that you could not.

Another strategy (if you want to help pay your child's or grandchild's college tuition) is to make tuition payments directly to the school instead of gifting assets to him or her. This payment wouldn't be subject to gift tax — another benefit of this approach.

If your child has only unearned income totaling less than $10,500 (2016), you may be able to include this on your tax return and not file a separate return for him or her.

COMPLEX DETAILS

The details involved in planning gifting strategies to avoid the kiddie tax can be complex. Contact your tax advisor to discuss your particular situation. •

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