Ideas & Trends

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Recent IRS regulations simplify Roth IRA rollovers

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Net operating losses

Losing money might have a silver lining

It's probably safe to say that your goal as a business owner is to make, not lose, money. But there are situations in which your company might be able to minimize the impact from business losses.

If your company's tax-deductible expenses exceed your taxable income in a given year, this results in a net operating loss (NOL). With proper planning, you might be able to use NOLs to reduce your tax liability.

COMPLEX RULES, SIMPLE CONCEPT

The IRS rules about NOLs can be complex, but the concept is relatively simple: NOLs allow businesses to use losses incurred in one year to offset income earned in other years, thus reducing taxable income and the amount of tax due in those profitable years.

NOLs can generally be carried back to the prior two tax years, or the prior three tax years in certain situations. Carrying back NOLs will enable you

How NOLs can save taxes

Here are several examples that help illustrate how NOLs can save a business tax dollars:

Example 1. Suppose your company has taxable income of $500,000 and deductible expenses of $700,000 this year. This would result in an NOL of $200,000. Two years ago, however, the numbers were reversed: You had taxable income of $700,000 and deductible expenses of $500,000, or a net profit of $200,000. You could carry this year's $200,000 NOL back to offset that year's $200,000 profit, which would result in no tax due and a refund of the taxes you paid for that year.

Example 2. Now let's suppose your company had a $100,000 profit two years ago and the same $200,000 NOL this year. You could carry back half of your NOL to offset that year's profit, leaving you another $100,000 to carry forward from two years ago to last year.

Example 3. Then imagine you broke even last year. In that case, you'd have $100,000 of the loss available to offset profits in future years. So if your company has a $50,000 profit each of the next two years, these profits could be offset by the remaining $100,000 NOL, resulting in no tax due in either of these years.

to recover past tax payments and result in a tax refund, thus boosting your current cash flow.

Alternatively, NOLs can be carried forward up to 20 years. In other words, you can offset income earned in future years with losses your business incurs now.

NOLs allow businesses to use losses incurred in one year to offset income earned in other years, thus reducing taxable income.

SHOULD YOU CARRY NOLs BACK OR FORWARD?

So which strategy makes more sense: carrying NOLs back to offset income in one or both of the prior two years or holding onto NOLs to possibly offset future income? The answer depends on several different factors.

First, how is your current cash flow? If it's relatively strong and you don't necessarily need a cash flow boost in the form of a current tax refund, you might decide to hold onto the NOL and save it for the future. Of course, this assumes that you anticipate having profitable years in the future.

But you also should consider the time value of money — in other words, the fact that tax savings realized now are inherently more valuable than those realized in the future. According to this thinking, it's more beneficial to carry NOLs back to reduce taxes in prior years and reap the tax benefits right away.

Another factor is whether you expect your business income to increase in future years and, if so, by how much? Higher business income in future years could push your company into a higher tax bracket. This would make NOLs more valuable in the future because they would be used to offset income that would otherwise be taxed at a higher rate.

If you have NOLs in more than one year, it's usually wise to exhaust all of the NOLs from the first year when they were created before using the losses from more recent years. If you have any remaining NOLs after 20 years, they will be canceled — so this strategy reduces the risk of losing the tax-saving benefits of your earlier losses.

TAX REFORM AND NOLs

With the new presidential administration, there's been a lot of talk about substantive tax reform. It's still too early to get a good sense of what that reform might look like, including whether it would impact the strategy of using NOLs to reduce taxes.

So, keep a close eye on tax reform developments going forward. And speak with your tax advisor about their possible effect on this tax-saving strategy. •

Do you know the secret to a strong cash flow?

Money coming in, money going out — that's what gives life to any business. But effectively managing cash inflows and outflows doesn't happen without strong intent and conscious planning. Let's look at the most important considerations for creating and maintaining strong cash flow.

FOLLOW THE FULL SALES CYCLE

The success of virtually any company depends on two cycles. From an operational point of view, the first is the *sales* cycle — that is, how long it takes your business to 1) develop, purchase or otherwise acquire a product or service; 2) market that product or service; and 3) eventually close a sale and collect the accounts receivable.

Indeed, collections — from clear, accurate invoicing to using bank lockboxes for faster access to money — is a major aspect of cash flow management.

Many companies either underestimate the impact of the selling cycle or lose sight of its gradual expansion. The former problem often affects start-ups: Entrepreneurs may believe they can get their wares to market, close deals and collect on them more quickly than reality allows.

The latter quandary, losing sight of the elongation of the sales cycle, can affect even well-established companies. Regular customers may start taking longer to pay. Or a major buyer might jump ship and be harder to replace than expected.

MANAGE THE DISBURSEMENTS CYCLE

The second cycle is the *disbursements* cycle. This is the process of managing the regular, outgoing payments to employees, vendors, creditors (including short- and long-term financing) and other parties. As payments go out, your cash flow is affected.

The selling and disbursements cycles aren't separate functions; they overlap. If they don't do so evenly, your delayed cash flow can create a crisis. That's why it's critical for business owners to understand the interaction between the money being spent to generate revenue and the revenue actually being generated.

That is, just as you work to match revenue to expenses, you also should ensure that your selling cycle (cash inflows, including outside financing) at least matches your disbursements cycle (cash outflows). Ideally, you're converting sales to cash more quickly than you're paying expenditures — thereby strengthening cash flow.

ACCOUNT FOR EVERYTHING

As your selling and disbursement cycles roll along, your company generates data. Failing to process this information

completely and accurately could lead to cash flow confusion — or worse.

That's why, if you're not leveraging the power of today's financial software, you're leaving yourself vulnerable to the whims of fortune. At a minimum, your accounting system should allow you to enter common transactions such as logging cash receipts onto deposit slips, cash disbursements onto checks, and purchase and sales transactions onto orders and invoices.

From there, review your use of ledgers. Every basic accounting system has a general ledger. But you may need a system with multiple subsidiary ledgers and special journals that simultaneously post when documents are saved.

Report generators are also critical for managing cash flow accurately. Your system should allow you to readily generate accounting reports — daily, weekly, monthly and annually. This means being able to easily record and access recurring transactions as well as accounts payable aging and payment scheduling.

Today's accounting systems also can provide you with a "dashboard" of real-time information, so you're less likely to be caught off guard by cash flow influencers. In addition, budgeting tools can help you set and monitor budgets, perform "What if?" analyses and compare actual results to goals.

USE YOUR FINANCIAL STATEMENT

The data gathered and generated by your accounting system eventually needs to end up in your financial statements. Yours should factor in the cash inflows and outflows of daily business operations, asset purchases, sales proceeds and financing activities. Because it excludes noncash accounting items, you can use it to pinpoint cash flow problems.

And once you have accurate financial statements, be sure to use the information they provide to help make any necessary adjustments as you move forward.

STRONG AND STEADY

Changes in commercial trends, dips in the economy and problematic customers all threaten to slow the stream of cash and compromise your business. But diligent management and accounting techniques, such as those mentioned above, can help cash flow at your company remain steady and strong. •

The benefits of donating appreciated stock

Making charitable donations is a high priority for many individuals and families. Doing so enables them to financially support charitable organizations and causes they believe in and may lower their income taxes.

Under current tax law, donations made to qualified charitable organizations — also known as 501(c)(3) organizations — may be tax-deductible during the year in which they're made. To deduct these contributions, you must itemize deductions on Schedule A (Form 1040) instead of claiming the standard deduction.

A DIFFERENT STRATEGY FOR GIVING

If you typically make charitable donations via cash or check, you might be able to increase your tax savings by rethinking your giving strategy. This involves donating property that has appreciated in value and that you've held for more than one year to the charity of your choice, instead of giving the charity cash. Usually, such property takes the form of publicly traded stocks or securities.

Appreciated securities you've owned for more than one year are considered to be long-term capital gains property. If you sell the securities and realize

the gain, you could be liable for paying capital gains taxes at a rate of 15% or 20% on the appreciated value of the stock. You also might have to pay an additional 3.8% net investment income tax (NIIT) on the gain if your modified adjusted gross income (MAGI) exceeds certain thresholds.

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But, if you donate the stock to charity, you won't owe capital gains taxes or the NIIT on the stock's appreciation. And the charity will receive the full fair market value of the security at the time the donation is made.

WHAT YOU COULD SAVE

An example helps illustrate how much money you could potentially save via this strategy. Let's say you paid $3,000 for a stock five years ago and today the stock is worth $10,000. And let's assume you're currently in the 39.6% tax bracket and subject to the top capital gains tax rate of 20% as well as the 3.8% NIIT.

If you sold the stock, you would only have $8,334 after paying capital gains taxes and the NIIT. If you're also subject to state income tax, the amount you'd have left to give to the charity would be even less. But if you donate the stock to your favorite charity, the charity will be able to receive the full $10,000 value — or at least $1,666 more than if you sold the stock and donated the proceeds to the charity.

Meanwhile, you'll realize a total savings of $5,626 in federal income taxes. This consists of $3,960 from the charitable donation itself and another $1,666 in capital gains tax and NIIT savings. If you had sold the stock and donated the proceeds net of your income tax liability, your charitable contribution of $8,334 would have yielded a federal tax deduction of just $3,300.

Keep in mind that donations of long-term capital gains property to public charities are subject to deduction limits of 30% of MAGI, compared to 50% of MAGI for cash donations to public charities.

POTENTIAL IMPACT OF TAX REFORM

It's worth noting that, during his presidential campaign, Donald Trump proposed capping itemized deductions and eliminating the NIIT. If these tax reforms are eventually enacted, they may have an impact on this strategy, though the game plan wouldn't necessarily be invalidated.

Consult with your tax advisor to discuss this and other tax-reduction strategies in detail. •

Recent IRS regulations simplify Roth IRA rollovers

Roth IRAs are a popular choice for many individuals wanting to enjoy tax-free growth and distributions of their retirement savings. In addition, many 401(k) plan participants create separate designated Roth accounts within their plan to hold their designated Roth contributions.

Thanks to final regulations released by the IRS in 2016, it's now easier and more efficient to transfer after-tax funds from designated Roth accounts to Roth IRAs or other designated Roth accounts. Many retirement savers will find this a plus because of the increased flexibility when it comes to making Roth IRA rollovers.

HOW WERE ROTH ACCOUNT DISTRIBUTIONS PREVIOUSLY TAXED?

Designated Roth accounts generally include both after-tax funds — or contributions made by plan participants — and pretax funds, or earnings on investments. Previously, when distributions were made from designated Roth accounts, they were considered to include a pro rata share of both after-tax and pretax funds. In general, the after-tax distributions aren't taxable, but the pretax distributions are.

When a distribution from a designated Roth account is rolled over, amounts directly rolled over are treated as distributions separate from amounts paid directly to employees. This is known as the "separate distribution rule." Before the final regulations took effect, a distribution that was split between a direct rollover to an eligible retirement account and a direct payment to an employee was treated as two distributions. The after-tax and pretax amounts were separately allocated pro rata to each distribution.

The result was that employees couldn't have the entire pretax portion of their distribution rolled over tax-free into a Roth IRA or designated Roth account. This is because some of the pretax portion of the distribution was considered to have been paid directly to the employee and thus subject to tax.

WHAT DOES ELIMINATING THE SEPARATE DISTRIBUTION RULE MEAN FOR YOU?

The final IRS regulations essentially eliminate the separate distribution rule. Rather than allocating the pretax amounts pro rata to the rollover and the employee payment, the pretax amounts will now be allocated to the rollover first. Thus, all of the pretax funds can now be allocated to the tax-free rollover, thus minimizing the amount that will be taxable when partial rollovers of nonqualified distributions are performed.

These final regulations are generally effective for distributions made on or after January 1, 2016.

Determining the best designated Roth account distribution and rollover options for your situation can be complicated. So be sure to contact your tax advisor to discuss your particular scenario in more detail. •

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