

ClientLine®

October 2014

Don't Take **LOAN COVENANTS** for Granted

When you take out a business loan, you should expect the final agreement to include covenants. Loan covenants are requirements and/or restrictions that lenders impose to limit their risk.

DOS AND DON'TS

There are different types of covenants. So-called *affirmative* covenants are things your lender requires you to do, such as providing regular financial statements, carrying certain insurance policies, making timely employment-tax payments, etc. *Negative* (restrictive) covenants prevent you from doing certain things without the lender's approval, such as borrowing from other sources, making management changes, selling equipment, etc.

SHOW THEM THE MONEY

Financial covenants require your company to maintain certain financial ratios related to working capital, net worth, debt, profitability, and cash flow. For example, a lender might require that a company maintain a specified debt service coverage ratio or debt-to-equity ratio for the life of the loan. These ratios are calculated using figures from your financial statements.

If your cash needs are unpredictable, you may decide to establish a line

of credit instead of taking out a loan. Line of credit lenders frequently limit risk by establishing a borrowing formula based on a certain percentage of current accounts receivable. If your agreement includes a condition like this, be sure to keep a close eye on accounts receivable aging and be proactive about collecting past due accounts.

NONCOMPLIANCE COULD BE COSTLY

Be proactive about protecting your interests when you are negotiating a loan.

Carefully review the loan agreement to identify all covenants and requirements. Make sure you fully understand them and have considered the possible repercussions before you

sign. If you violate a covenant, your loan is technically in default and your

lender may choose to call the loan, take the collateral, or substantially modify the terms of your agreement.



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Making Savings Last

Managing retirement savings to last a lifetime can be a challenge, especially for people who won't receive a traditional pension. New tax regulations may encourage employers to offer "qualified longevity annuity contracts," or QLACs, as an option in their 401(k) plans.

A QLAC is a deferred income annuity that provides a guaranteed income stream beginning at an advanced age and continuing for life. Under the regulations, an eligible plan may allow participants to use up to 25% of their account balances or (if less) \$125,000 to purchase a QLAC. Distributions from the annuity must begin no later than age 85. A QLAC may have a "return of premium" death benefit feature.

The regulations also allow other qualified defined contribution plans, 403(b) plans, eligible governmental 457(b) plans, and traditional individual retirement accounts to offer a QLAC option.

NONPROFITS:

Don't Ignore These Tax Issues

The tax-exempt status that nonprofit organizations enjoy does not relieve them of all tax-related concerns. If you are involved with a nonprofit in a leadership capacity, you'll want to understand the tax issues that could affect your organization. Here is a brief rundown.

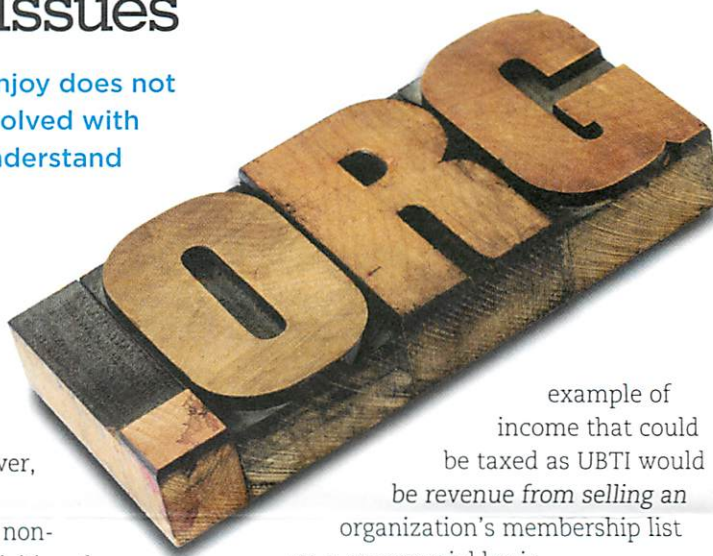
Exemption application. An organization cannot simply assume it is exempt from income taxes because it is operated as a nonprofit. A formal application for tax exemption must be submitted to the IRS. Section 501(c) of the Internal Revenue Code describes several types of organizations that can qualify for exemption. Section 501(c)(3) public charities are an example.

Annual IRS filings. Nonprofit organizations (other than religious organizations) generally must file an annual information return (Form 990 or 990-EZ) with the IRS. Very small nonprofits having gross receipts of less than \$50,000 may electronically submit Form 990-N (known as the e-Postcard). If your organization uses the calendar year for tax reporting purposes, the deadline for filing your 2014 return is May 15, 2015.

Unrelated business income. Income that is substantially related to the

pursuit of your organization's exempt purpose generally is not subject to income taxes. However, if your organization regularly engages in non-exempt business activities, the net income from those activities would be subject to tax as unrelated business taxable income (UBTI). Although unrelated business income can be a helpful source of revenue, exercise caution. When it becomes "substantial," it can threaten an organization's exempt status.

You can't assume that an activity is related to your organization's exempt function simply because it raises needed funds for the organization. The IRS looks at the activity itself, not the use of the income generated by the activity. An



example of income that could be taxed as UBTI would be revenue from selling an organization's membership list on a commercial basis.

Executive compensation. The IRS carefully scrutinizes the compensation and benefits received by charitable organization executives for reasonableness. It has the authority to levy costly penalties (called "intermediate sanctions") on those involved in "excess benefit transactions."

Donor receipts. If your organization is a Section 501(c)(3) organization that solicits tax-deductible contributions from the general public, you'll want to be sure you are providing donors with the required records they need to substantiate their deductions.

Client PROFILE.....

Emma had planned to use her federal income-tax refund for a vacation with her family. But when she filed last year's tax return, she discovered she had to send the IRS a check.

Emma could have avoided this outcome by having more tax withheld from her paychecks. With the end of this tax year coming, she might want to consider some tax planning strategies to help reduce her 2014 taxes.

Increasing deductions is one way to reduce taxes. Any cash contributions Emma makes to a qualified charity before the end of the year are potentially deductible as an itemized deduction. She can also deduct the fair market value of donated clothes and household items that are in good used (or better) condition. In both cases, she should have appropriate records.

Medical expenses are generally deductible only to the extent they exceed 10% of adjusted gross income

(7.5% if age 65 or older). If Emma thinks she'll exceed that "floor," she might want to schedule and pay for elective medical and dental procedures before December 31 to boost her deduction. If she won't exceed the floor, she might consider deferring expenses so they count in 2015. The same "bunch or defer" strategy works for miscellaneous itemized expenses, which must exceed a 2%-of-adjusted-gross-income floor.

A year-end tax review may uncover last-minute tax moves that can help reduce 2014 tax liability.

Client Profile is based on a hypothetical situation. The solutions we discuss may or may not be appropriate for you.

What To Do with **EXTRA CASH**

If you came into some money unexpectedly and you had to use it to either pay down your debt or invest it, which would you choose?

MATHEMATICALLY SPEAKING ...

One way to decide is to look at the numbers. If you can earn a higher rate of return by investing than the interest rate you're paying on your debt (after considering taxes), then investing puts you ahead of the game. Alternatively, if the interest rate on your debt is higher than you can reasonably expect to earn on your investments, eliminating debt is better.

Say your debt is a home mortgage with a 5% interest rate. Mortgage interest is generally tax deductible. If you're in the 28% income-tax bracket, the after-tax interest rate on your mortgage is $5\% - (5\% \times 0.28) = 3.6\%$. If you can earn an after-tax return of more than 3.6% by investing your money, then that's the better deal.

Alternatively, if your debt is an unpaid credit card balance with a high interest rate, you may be better off eliminating your debt.

OTHER FACTORS TO WEIGH

In addition to the math aspect, there may be a psychological aspect to your decision (e.g., how you feel about being in debt). And don't underestimate investment risk. If your investments do poorly, you could lose principal.

Also think about what you would do if you needed money quickly. Before you use your extra cash to pay off debt, consider whether your emergency fund is adequate.

Is Your **VENDOR LIST** Hiding Something?

If it is, the "something" could be internal fraud. Internal fraud is something businesses of all sizes need to guard against. If your vendor list is more than just a few entries and if others have access to it, you should be diligent about reviewing it on a regular (but random) basis.

CH-CH-CH-CHANGES

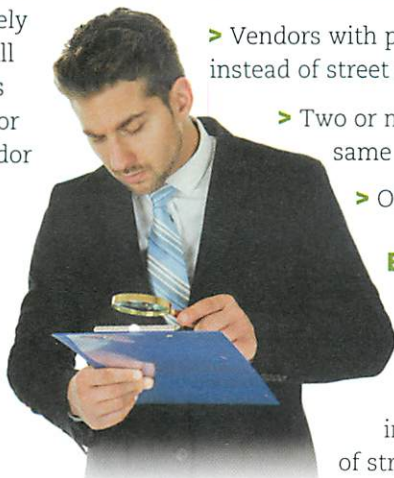
Vendor fraud is relatively simple to perpetrate. All someone needs to do is create a "new" vendor or switch an inactive vendor to active and make a few strategic changes. Payments to the faux vendors can then be funneled to the fraudster's or an accomplice's bank account.

Here are some other potential red flags:

- > Recent address changes
- > Vendors with post office boxes instead of street addresses
- > Two or more vendors at the same address
- > Off-schedule payments

BE PROACTIVE

Attentiveness can help deter internal fraud. However, the best protection is to implement a system of strong internal controls.



... Q&A



My wife and I own a specialty food company. We're launching a new product line and want to isolate the business in a newly formed subsidiary. Our company is an S corporation. Can the subsidiary be organized as an S corporation also?



An S corporation can have a wholly owned QSub (qualified Subchapter S subsidiary). Your existing company would have to own 100% of the new company and make an election to treat the new company as a QSub. A QSub generally is not treated as a separate corporation for federal tax purposes.



I own an underperforming stock that I believe will eventually rebound. I'm thinking about selling the stock and then immediately repurchasing shares in the same company. That way, I'd generate a capital loss to offset my capital gains on earlier investment transactions and still own the stock. Would this work?



The tax law's "wash-sale rule" limits the use of this strategy. Under the rule, you can't claim a capital loss on a securities sale if you buy "substantially identical" securities within 30 days before or after the sale. If you want to claim the loss in this case, you'd have to wait at least 31 days after selling your shares to repurchase the stock.

ClientLine ITEMS.....

> ALTHOUGH JOB SATISFICATION LEVELS HAVE RISEN since the Great Recession, a majority of Americans remain dissatisfied with their jobs, according to a survey from The Conference Board performed in late 2013. The survey found that only 47.7% of American workers were satisfied with their jobs.

> THE POPULATION OF OLDER AMERICANS IS GROWING. In 2010, 40.3 million people were age 65 and older, 12 times the number in 1900, according to the U.S. Census Bureau. The population of

older Americans increased from 4.1% of the total U.S. population in 1900 to 13% in 2010. By 2050, the percentage is projected to swell to 20.9%.

> EMPLOYERS OWED THE IRS approximately \$14.1 billion in delinquent employment taxes at the end of June 2012. An audit by the Treasury Inspector General for Tax Administration (TIGTA) found that the IRS's Trust Fund Recovery Penalty (TFRP) actions to collect the unpaid taxes were not always timely or adequate. TIGTA recommends that the IRS emphasize

to group managers their responsibilities to monitor TFRP cases and ensure that revenue officers take timely TFRP actions.

> RETIREE HEALTH CARE BENEFITS provided by employers are becoming a thing of the past. The Kaiser Family Foundation reports that only 28% of employers with more than 200 employees offered health benefits to their retiring workers in 2013, down from 66% in 1988.

The general information provided in this publication is not intended to be nor should it be treated as tax, legal, investment, accounting, or other professional advice. Before making any decision or taking any action, you should consult a qualified professional advisor who has been provided with all pertinent facts relevant to your particular situation.

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