Tax Impact

Cash vs. accrual

Are you using the right accounting method?

2 homes in different states may result in multistate taxation

Building an on-off switch into your estate plan

Tax Tips

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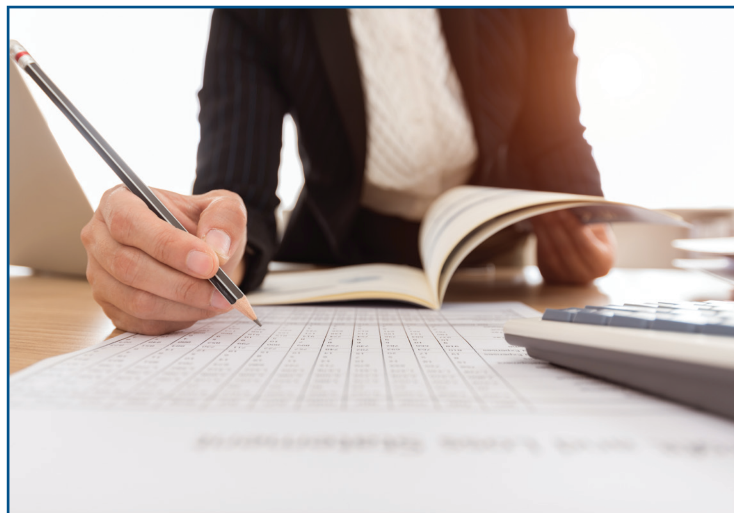


Which accounting method should your business be using for tax purposes? Many business owners are surprised to learn that they have a choice. True, certain businesses are required to use the accrual method, but you'd be surprised how many businesses are eligible for the cash method. If you have the option to use either accounting method, it pays to consider whether switching methods would lower your tax bill.

Here's a closer look at which businesses are eligible to choose either the accrual or cash method — and the relative advantages and disadvantages of each. Keep in mind that cash and accrual are the two primary tax accounting methods, but they're not the only ones. Some businesses may qualify for a different method, such as a hybrid of the cash and accrual methods.

Cash method availability

Generally, a business is permitted to use the cash method of accounting for tax purposes unless it's 1) expressly *prohibited* from using the cash method, or 2) expressly *required* to use the accrual method. Businesses prohibited from using the cash method include C corporations and partnerships with a C corporation partner, unless one of the following exceptions applies:

- The business's average annual gross receipts for the previous three tax years are $5 million or less.
- The business is a qualified personal service corporation. This includes law, accounting, consulting, engineering and architecture firms — and certain other service providers — whose stock is substantially owned by current or retired employees or their estates.

Special rules apply to farming businesses, and tax shelters are always prohibited from using the cash method.

The following types of businesses generally are required to use the accrual method:

- Businesses with income from long-term contracts (such as construction firms and manufacturers), which generally must use the percentage-of-completion method.
- Businesses with inventories, with certain exceptions. (See "A note on inventories" on page 3.)

If your business isn't prohibited from using the cash method or required to use the accrual method, evaluate your current method to be sure it's the right one for your business. Also be aware that it's possible for a business to use both the cash and accrual methods if, for instance, the business is made up of multiple businesses for which different rules apply.

Weigh the pros and cons

Generally, cash-basis businesses recognize income when it's received and deduct expenses when they're paid. Accrual-basis businesses, on the other hand, recognize income when it's earned and deduct expenses when they're incurred, without regard to the timing of cash receipts or payments. The cash method offers several advantages, including:

- Simplicity. It's easier and cheaper to implement and maintain.
- Tax-planning flexibility. It offers greater flexibility to control the timing of income and deductions. For example, it allows you to defer income to next year by delaying invoices or to shift deductions into this year by accelerating the payment of expenses. An accrual-basis business doesn't enjoy this flexibility. For example, to defer income, delaying invoices wouldn't be enough; the business would have to put off shipping products or performing services.
- Cash flow benefits. Because income is taxed in the year it's received, the cash method does a better job of ensuring that a business has the funds it needs to pay its tax bill.

If your business prepares GAAP-compliant financial statements, you can still use the cash method for tax purposes.

Although the cash method is preferable for most businesses, the accrual method has some advantages. For one thing, it does a better job of matching

A note on inventories

The tax rules involving inventories are complex, but, in a nutshell, if the production, purchase or sale of "merchandise" is an "income-producing factor" for your business, you must account for inventory and use the accrual method for purchases and sales. (It's possible to use a hybrid method that allows you to use the cash method for items other than purchases and sales.)

We won't go into the details of inventory accounting, distinguishing between merchandise and "materials and supplies," or determining whether merchandise is an income-producing factor. It's important to be aware, however, that the IRS has created two exceptions to these requirements. A business isn't required to account for inventory or use the accrual method if:

- It meets a less-than-$1 million average gross receipts test (unless it's otherwise prohibited as a tax shelter), or
- It meets a less-than-$10 million average gross receipts test and its principal business activity *is not* classified as mining, manufacturing, wholesale trade, retail trade or information industries.

Note that, while businesses qualifying for these exceptions may use the cash method as their overall tax accounting method and needn't account for inventory, they must treat merchandise as "nonincidental materials and supplies" for tax purposes. That means merchandise costs are deductible when paid or when the merchandise is sold, *whichever is later.*

income and expenses, so it provides a more accurate picture of a business's financial performance. That's why it's required under Generally Accepted Accounting Principles (GAAP). If your business prepares GAAP-compliant financial statements, you can still use the cash method for tax purposes, but it's important to weigh the cost of maintaining two sets of books against the potential tax benefits.

In some cases, the accrual method may offer tax advantages. For example, if your business's accrued income tends to be lower than its accrued expenses, the accrual method may lower your tax bill. Also, accrual-basis businesses can take advantage of certain tax-planning strategies that aren't available to cash-basis businesses, such as deducting year-end bonuses that are paid within the first 2½ months of the following year, and deferring income on certain advance payments.

Making a change

If your business is eligible for both the cash and accrual methods, ask your tax advisor whether switching methods would lower your taxes. Depending on your circumstances, changing accounting methods may require IRS approval. ■

2 homes in different states may result in multistate taxation

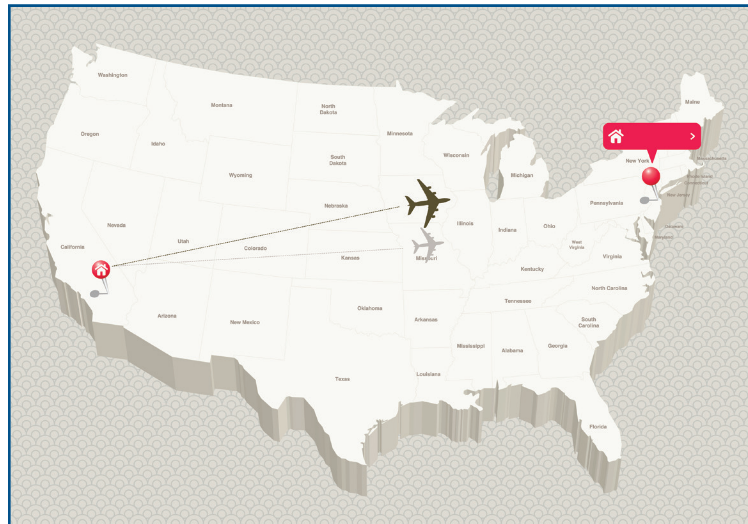
Because Kyle often travels between two states for work, he decided to buy a condo on the East Coast in addition to his house on the West Coast. What Kyle didn't take into consideration was the double taxation of his income that resulted from his real estate purchases.

Domicile matters

Multistate taxation laws are complex and vary from state to state. But, in a nutshell, if you're domiciled in a state, that state has the power to tax your worldwide income. Your domicile is the place where you have your "true, fixed, permanent home."

Once you establish domicile in a state, it remains there until you establish domicile in another state. The key to determining your domicile isn't how much *time* you spend in a place, but rather your *intent* to remain there indefinitely or to return there.

States also have the power to tax the worldwide income of statutory residents. You can have only one domicile, but it's possible to be a resident of two or more states. Typically, you're a resident of a state if you maintain a "permanent place of abode" and you spend a minimum amount of



time there during the year (such as "more than 183 days" or "more than six months").

Also, states have the power to tax income derived from a source within the state, even if you're not a domiciliary or resident. For example, if you commute across the border for a job in another state, your wages are taxable by the state where you work.

An example

There are several ways in which the same income can become taxable by more than one state. Let's take a closer look at Kyle's situation. He is domiciled in state A but commutes regularly to state B for business. Assume that the residency threshold in state B is 183 days. If he spends more than 183 days in state B and maintains a permanent place of abode there, state B may tax him as a resident, while state A taxes him as a domiciliary. And keep in mind that partial days are often included as full days. One possible way to avoid this result is to not own or rent an apartment or house (even a vacation home) in state B.

Many states offer credits for taxes paid to other states. For example, suppose state A allows residents domiciled in other states to claim a credit for taxes paid to those states, but only if those states offer a reciprocal credit to their residents domiciled in state A. In the above example, if state B doesn't allow such a credit, Kyle's income is taxable in both states.

Meet with your tax advisor

If you are currently splitting your time between two or more states, it's critical to discuss your situation with your tax advisor. ■

Building an on-off switch into your estate plan

When planning your estate, there can be tension between estate tax planning and income tax planning. Strategies for reducing estate taxes typically focus on removing assets from your estate, while strategies for reducing income taxes typically focus on *including* assets in your estate.

The right strategy for you is the one that will produce the greatest tax savings for your family. But that can be difficult to predict. Even if income taxes are the bigger concern now, changes in the tax laws or in your financial circumstances down the road can turn your strategies on their heads.

Fortunately, with careful planning, it's possible to build an "on-off switch" into your estate plan. The idea is to remove assets from your estate today, but design a mechanism for funneling those assets back into your estate if that turns out to be the better strategy.

Why the conflict?

Generally, the best way to minimize estate taxes is to remove assets from your estate as early as possible (through outright gifts or gifts in trust) so that all future appreciation in value escapes estate tax. But these lifetime gifts can increase income taxes for the recipients of appreciated assets. That's because assets you transfer by gift retain your tax basis, potentially resulting in a significant capital gains tax bill should your beneficiaries sell them.

Assets held for life, on the other hand, receive a stepped-up basis equal to their fair market value on the date of death. This provides a big income tax advantage: Your beneficiaries can turn around and sell the assets with little or no capital gains tax liability.

Until relatively recently, estate planning strategies focused on minimizing estate taxes, with little regard for income taxes. Why? Because historically the highest marginal estate tax rate was significantly higher than the highest marginal income tax rate and the estate tax exemption amount was relatively small. So, in most cases, the potential estate tax savings far outweighed any potential income tax liability.

Today, the stakes have changed. The highest marginal estate and income tax rates are comparable (40% and 39.6%, respectively) and the estate tax exemption has climbed to $5.49 million for 2017. Let's suppose Jim's estate consists of $5.49 million in stock with a tax basis of $1.49 million. If he holds onto the stock and leaves it to his daughter at his death, she'll enjoy a stepped-up basis. Assuming the stock is still worth $5.49 million, and the capital gain is taxed at a 23.8% rate, Jim's daughter avoids a $952,000 tax bill when she sells the stock. Had Jim given the stock to his daughter instead, and she then sold it and realized a gain of $4 million, she would have owed the $952,000. There would be no estate tax savings because, in this example, there is nothing left in Jim's estate.

If, on the other hand, the stock appreciates significantly in value, the outcome will be different. Suppose the stock's value has increased to $12.49 million when Jim dies, and there's been no change to either the capital gains rate or estate tax exemption amount. Holding the stock will allow Jim's daughter to avoid $2,618,000 in capital gains taxes upon the sale of the stock ($11 million × 23.8%), but it will trigger $2.8 million in estate taxes ($7 million × 40%).

Flipping the switch

With a carefully designed trust, you can remove assets from your estate while giving the trustee the ability to direct the assets back into your estate should that prove to be the better tax strategy in the future. There are different techniques for accomplishing this, but typically it involves establishing an irrevocable trust over which you retain no control (including the right to replace the trustee) and giving the trustee complete discretion over distributions.

> ***Until relatively recently, estate planning strategies focused on minimizing estate taxes, with little regard for income taxes.***

If it becomes desirable to include the trust assets in your estate, the trustee can accomplish this by, for example, naming you as successor trustee or granting you a power of appointment over the trust assets.

A flexible tool

It's difficult to predict how your financial circumstances will change in the future and whether Congress will change the income or estate tax laws. An irrevocable trust provides your trustee with the flexibility to react to these changes and achieve the best tax result for you and your family. ■

Home sale exclusion: Unexpected birth is "unforeseen circumstance"

The unexpected birth of a child qualified as an "unforeseen circumstance" in a recent IRS Private Letter Ruling. The IRS permitted the parents in this case to exclude the gain on the sale of their two-bedroom condo because of the unexpected birth, even though they didn't meet the "two-out-of-five-years" requirement.

Internal Revenue Code Section 121 allows you to exclude from income up to $250,000 in gain ($500,000 for married couples filing jointly) on the sale of a principal residence. To qualify, you must own and use the home as your principal residence for at least two years during the five-year period before the sale. There's an exception, however, for unforeseen circumstances, such as changes in employment, health issues and, according to the Letter Ruling, the unexpected birth of a child. In that case, the couple already had one child and the unplanned pregnancy rendered the condo unsuitable.

Be aware that, in the event of unforeseen circumstances, the exclusion is prorated. ■

Extra time granted for portability election

In a recent Revenue Procedure, the IRS permitted certain estates to make a late portability election without filing a ruling request. Portability allows a surviving spouse to take advantage of a deceased spouse's unused estate tax exclusion (currently, $5.49 million), but only if the deceased spouse's executor makes an election on a timely filed estate tax return (even if a return isn't otherwise required).

Ordinarily, the only way to file a late portability election is to request a Private Letter Ruling from the IRS, which can be an expensive, time-consuming process. The Revenue Procedure grants an automatic extension for taxpayers not otherwise required to file an estate tax return. That's provided they file a return making the election on or before the *later* of 1) the second anniversary of the deceased's death, or 2) January 2, 2018. ■

A tax-free Roth IRA for your kids

Contributions to Roth IRAs are nondeductible, but qualified withdrawals are tax-free. However, if your dependent children work after-school or summer jobs, they can take advantage of a tax-free Roth IRA. How? Kids can earn up to the standard deduction amount (currently, $6,350) tax-free and contribute 100% of their earned income or $5,500, whichever is less, to a Roth IRA. The bottom line: Both contributions and withdrawals are tax-free. And so long as your kids have earned income, it doesn't matter if the contributions come from their funds or yours. ■

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