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Tax & Business Alert

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WHY YOU SHOULD (OR SHOULDN'T) PURSUE AN ACQUISITION

Like so many aspects of the national and global economies, merger and acquisition (M&A) activity tends to wax and wane. Nonetheless, billions of dollars continue to change hands annually, and an acquisition can be a great way to grow a business. So if one of these deals comes your way, it's important to carefully consider both the pros and cons.

LOOK AT THE POSSIBILITIES

Merging with, or acquiring, another company is one of the best ways to grow rapidly. You might be able to significantly boost revenue, literally overnight, by acquiring another business. Achieving a comparable rate of growth organically — by increasing sales of existing products and services or adding new product and service lines — can take years.

An acquisition also might enable your company to expand into new geographic areas and new customer segments more quickly and easily. You can do this via a horizontal acquisition (acquiring another company that's similar to yours) or a vertical acquisition (acquiring another company along your supply chain).

In addition, you can realize synergies by acquiring the right type of company. Synergies are business characteristics and capabilities that complement and work well with those of your own company. The idea is to find an acquisition target that offers the right synergies so that the new combined entity will be stronger than either business would have been on its own.

BE AWARE OF DRAWBACKS

Although there are many potential benefits to acquiring another business, there are some potential drawbacks as well. For example, completing an acquisition is a costly process, from both a financial and a time-commitment perspective.

Therefore, you should determine how much the transaction will cost and how it will be financed *before* beginning the M&A process. Also try to get an idea of how much time you and your key managers will have to spend on M&A-related tasks in the coming months — and how this could impact your existing operations.

A loss of control is another potential drawback to consider. Depending on the deal's structure, some degree of control may have to be shared with the owners of the business you're acquiring, especially if the owners aren't retiring but intend to be actively involved with the merged entity.

It's also critical to try to ensure that the cultures of the two merging businesses will be compatible. Mismatched corporate cultures have been the main cause of numerous failed mergers, including some high-profile megamergers. For instance, if one company has a more formal and buttoned-down culture while the other is more casual and laid back, conflicts will likely ensue unless you plan carefully for how the two divergent cultures will be blended together.

PERFORM DUE DILIGENCE

The best way to reduce the risk involved in buying another business is to perform solid due diligence on your acquisition target. Your objective should be to confirm claims made by the seller about the company regarding its financial condition, clients, contracts, employees and management team.

The most important step in M&A due diligence is a careful examination of the company's financial statements — specifically, the income statement, cash flow statement and balance sheet. Also scrutinize the existing client base and client contracts (if any exist) because projected future earnings and cash flow will largely hinge on these.

Finally, try to get a good feel for the knowledge, skills and experience possessed by the company's employees and key managers. In some circumstances, you might consider offering key executives ownership shares if they'll commit to staying with the company for a certain length of time after the merger.

MAP YOUR COURSE

An acquisition is one way to expand and grow your company. But be sure to map your course thoroughly before heading down the M&A road. Our firm can help steer you in the right direction. ■

LEASING PROPERTY TO YOUR BUSINESS MIGHT TRIGGER UNDESIRABLE TAX CONSEQUENCES

If you own property and a business, there's an obvious temptation to lease that property to the business. Such an arrangement can make sense from many perspectives.

You're no doubt familiar with the property and its advantages to your company; the deal could be carried out quickly; and the money changing hands would stay between you and your company. And if you participate in other loss-producing passive activities, you may be hoping to offset the net rental income with those losses.

There's just one big problem: You'd risk triggering the "self-rental rule" and not achieving your desired tax outcome.

SELF-RENTAL RULE IN A NUTSHELL

Internal Revenue Code (IRC) Section 469 generally prohibits taxpayers from deducting passive activity losses (PALs).

It typically applies to "flow-through" income and losses from partnerships, limited liability companies (if they've elected to be treated as a partnership for tax purposes), S corporations and trusts.

The rules define "passive activity" as any trade or business in which the taxpayer doesn't materially participate. Rental real estate activities generally are considered passive activities regardless of whether the taxpayer materially participates. (There's an exception if the taxpayer qualifies as a real estate professional.)

A PAL is the amount by which the taxpayer's aggregate losses from all passive activities for the year exceed the aggregate income from all of those activities. A PAL can usually be used only to offset passive income, though there are a few exceptions.

The self-rental rule in IRC Sec. 469 applies when you rent property to a business in which you or your spouse materially participates. Under the rule, any net rental losses are still considered passive, but the net rental income is deemed nonpassive. That means your net rental income can't be offset by other passive losses, yet net rental losses generally can offset only other passive income. This could have negative tax consequences if you're hoping to offset your self-rental net income with passive losses from other activities.

THE POWER OF GROUPING

You may be able to avoid the negative tax consequences of IRC Sec. 469's self-rental rule by "grouping." The regulations allow you to group your separately owned rental building with your business to treat them as one activity for purposes of the passive loss rules if they constitute an "appropriate economic unit."

The regulations determine this based on factors such as common ownership and control, types of activities and location. As long as you materially participate in the business — and the business isn't a C corporation — the rental activity won't be treated as passive for the purposes of income or losses.

To take advantage of this option, you must own both the rental property and the business. You could also use grouping if the rental activity is "insubstantial" (a term undefined by the regulations) in relation to the business activity.

FINDING THE BEST ARRANGEMENT

Renting property to a business in which you materially participate can seem like a great idea. But doing so can turn out to be a lose-lose proposition when it comes to taxes — particularly for S corporation owners who may not understand the rules. Please contact our firm for help devising the most beneficial arrangement for your situation. ■

WHICH TYPE OF MORTGAGE LOAN MEETS YOUR NEEDS?

Few purchases during your lifetime will be as expensive as buying a home. Whether it's your primary residence, a vacation home or an investment property, how you choose to pay for it can have a significant impact on your financial situation over time. If you're considering a mortgage loan, understanding the main categories of mortgages — fixed-rate and adjustable-rate — and the situations they're best designed for will help you match the right type for your needs.

FIXED-RATE LOANS OFFER STABILITY

A fixed-rate mortgage, as its name suggests, is a loan whose interest rate remains constant for the life of the loan — typically 15 or 30 years. One of the primary benefits of a fixed-rate loan is that it provides a measure of certainty about one of the biggest expenses in your monthly budget. With interest rates likely to rise after an extended period of historically low rates, you won't have to worry about potentially higher payments in the future if you select a fixed-rate loan.

That said, if interest rates were to fall again, your fixed-rate loan would leave you unable to take advantage of the shift unless you refinance, which might involve fees. You're also paying a premium for the stability offered by a fixed-rate mortgage. You could consider a 15-year fixed-rate loan, which would charge a lower rate than a 30-year loan, but the tradeoff will be higher monthly payments.

ARMs PROVIDE FLEXIBILITY

Adjustable-rate mortgages (ARMs) typically offer a fixed interest rate for an initial period of years. This rate, which is usually lower than that of a comparable fixed-rate mortgage, resets periodically based on a benchmark interest rate. For example, a 5/1 ARM means that your interest rate is fixed for the first five years and then will adjust every year after that.

Paying less interest in the beginning frees your cash for other investments. You might also take advantage of an ARM if you're confident that you'll have more money in the future than you do today, or if you plan on selling your house before or soon after the initial fixed-rate period expires. When considering an ARM, you'll need to assess your ability to keep up with potentially higher payments — say, if the initial period expires, your rate goes up and you're unable to sell the home, or if your income changes.

THE BEST FOR YOU

The right loan type depends, naturally, on your financial position. But whether you're buying a primary residence, vacation home or investment property also plays a role. Regardless of which type of home you're purchasing, having a basic knowledge of the loan types can help ease the buying process. Let our firm assist you in evaluating the best mortgage for your needs. ■

TAX CALENDAR

July 17

If the monthly deposit rule applies, employers must deposit the tax for payments in June for Social Security, Medicare, withheld income tax and nonpayroll withholding.

July 31

If you have employees, a federal unemployment tax (FUTA) deposit is due if the FUTA liability through June exceeds $500.

- The second quarter Form 941 ("Employer's Quarterly Federal Tax Return") is also due today. (If your tax liability is less than $2,500, you can pay it in full with a timely filed return.) If you deposited the tax for the quarter in full and on time, you have until August 10 to file the return.

August 15

If the monthly deposit rule applies, employers must deposit the tax for payments in July for Social Security, Medicare, withheld income tax and nonpayroll withholding.

September 15

Third quarter estimated tax payments are due for individuals, trusts and calendar-year corporations.

- If a six-month extension was obtained, partnerships should file their 2016 Form 1065 by this date.
- If a six-month extension was obtained, calendar-year S corporations should file their 2016 Form 1120S by this date.
- If the monthly deposit rule applies, employers must deposit the tax for payments in August for Social Security, Medicare, withheld income tax, and nonpayroll withholding.

KNOW YOUR TAX HAND WHEN IT COMES TO GAMBLING

A royal flush can be quite a rush. But the IRS casts a wide net when defining gambling income. It includes winnings from casinos, horse races, lotteries and raffles, as well as any cash or prizes (appraised at fair market value) from contests. If you participate in any of these activities, you must report such winnings as income on your federal return.

If you're a casual gambler, report your winnings as "Other income" on Form 1040. You may also take an itemized deduction for gambling losses, but the deduction is limited to the amount of winnings.

In some cases, casinos and other payers provide IRS Form W-2G, "Certain Gambling Winnings" — particularly if the entity in question withholds federal income tax from winnings. The information from these forms needs to be included on your tax return.

If you gamble often and actively, you might qualify as a professional gambler, which comes with tax benefits: It allows you to deduct not only losses, but also wagering-related business expenses — such as transportation, meals and entertainment, tournament and casino admissions, and applicable website and magazine subscriptions.

To qualify as a professional, you must be able to demonstrate to the IRS that a "profit motive" exists. The agency looks at a list of nonexclusive factors when making this determination, including:

- Whether the taxpayer conducts the gambling activity in a "businesslike" manner,
- The quantity of time spent gambling, and
- How much income is earned from *non*gambling activities.

But don't "go pro" for the tax benefits, since doing so is a major financial risk. If you enjoy the occasional game of chance, or particularly if you're considering gambling as a profession, please contact our firm. We can help you manage the tax impact. ■