THE YEAR YOU START HATING YOUR ACCOUNTANT

BY ALAN FRIEDMAN

TAX LAW CHANGES WILL MAKE TAX YEAR 2014 A LITTLE TOUGHER TO SWALLOW

Hold on to your hat and wallet. Tax year 2014 will become the year you start disliking your accountant, through no fault of their own. Most accountants love being a superhero for their clients, as they guide them through the dark alleys of our tax code and protect law-abiding citizens from that feared predator commonly referred to as Uncle Sam. Yes, these tax-fighting number-crunching superheroes slap down Uncle Sam's outstretched grubby hands with brilliant tax planning ideas and legitimate business deductions, credits and deferrals.

But calendar year 2014 will unfortunately greatly reduce the power of these tax fighting supporters with some new kryptonite-fueled tax law changes. It will also render many businesses (especially school music dealers) easy prey to Uncle Sam's voracious appetite for tax collection, as the tax superhero's most powerful weapons — the Section 179 and bonus depreciation deductions — have now been significantly reduced and stripped away. So let me be the first to forewarn you of the impending tax doom that will, with one hand on your tax return and the other one in your wallet, rear its ugly head by April 15, 2015.

SECTION 179 DEFINED

Let me first start with a brief explanation of the tax term Section 179. This term refers to Sec. 179 of the U.S. Internal Revenue Code and lets a taxpayer elect to deduct the cost of certain types of business property on their tax return as an expense, rather than requiring the cost of that property to be capitalized and depreciated over time. Qualifying property is generally limited to tangible, depreciable, personal property acquired by purchase for use in an active trade or business. Although buildings were not eligible for Sec. 179 deductions prior to the passage of the Small Business Jobs Act of 2010, certain qualified real property may be deducted now.

The Sec. 179 election may be made only for the year the equipment is placed in service, it's generally irrevocable, and it's subject to certain dollar limitations. Lastly, the Sec. 179 deduction for any taxable year may not exceed the taxpayer's aggregate income from their active involvement in a trade or business for that year.

THE GOOD OLD DAYS

As part of last year's January 2013 fiscal cliff deal, Congress extended the 50-percent bonus depreciation and the more robust Sec. 179 expensing deduction through the end of 2013. Businesses — including self-employed sole proprietorships — could purchase up to $2 million of new or used capital assets and elect to immediately expense or "write off" the entire (100 percent) cost of those purchases up to $500,000, instead of being forced to depreciate them over their typical three, five and/or seven-year useful life. This immediate tax deduction provided many business owners with literally tens of thousands of dollars annually saved in federal and state tax.

Any new capital assets that couldn't be immediately expensed could then at least enjoy a 50-percent bonus depreciation write-off on those purchases. In some circumstances, the bonus depreciation can be more valuable than the Sec. 179 break because the Sec. 179 deduction is limited to business taxable income and any excess unused Sec. 179 deduction must be carried forward. But if you're actively involved in running a business, the 50-percent bonus depreciation not only lets you deduct losses, it generates against other income, but you can also carry any unused losses back for two years and get a refund check from Uncle Sam.

These deductions were especially valuable to those businesses which faced new higher tax rates for 2013, including the Medicare surtax on wages and self-employment income. We saw many music retailers (especially school music dealers, with recurring rental instrument purchases who had not yet exceeded the Sec. 179 expensing limits) make needed capital asset purchases at the end of 2013 to take advantage of these disappearing deductions. In short, these tax savings were huge and business owners got spoiled by getting used to them.

THE NOT-SO-GOOD NEW DAYS

Now that 2013 is nothing more than a fading memory, business owners will think twice about both making expansive capital purchases (like computers, store furniture and fixtures, vehicles, leasehold improvements and instrument rental pools) and how they go about financing these purchases. Why? Because any purchase of capital assets will no longer deliver the same kind of dollar-for-dollar tax-saving deduction it has in the past, leaving many businesses with significantly higher tax bills at the end of their fiscal year. Under the current law, the Section 179 deduction drops from $500,000 to a mere $25,000 on capital asset purchases up to $200,000. And the 50-percent bonus depreciation is now totally gone. The loss of these vital tax deductions and resulting federal and state tax liabilities will, for the first time in a long time, dramatically impair the cash reserves of many businesses when they're forced to write big fat tax checks in March/April of 2015.

SO HOW MUCH WE TALKIN' ABOUT?

While many businesses will feel the tax pain of this vanishing deduction in varying degrees, nobody in MI retailing will feel it more than school music dealers who are actively involved in renting band and

orchestral musical instruments. The same is true for keyboard dealers actively renting pianos and organs, and combo/MI dealers actively renting large amounts of backline gear. For many of these music dealers, annual purchases of new and/or replacement instruments for their rental pools typically range from tens of thousands to hundreds of thousands of dollars. Irrespective of whether those purchases are financed or paid for out of operating cash flow, the tax bite from buying large quantities of capital assets without receiving an offsetting dollar-for-dollar tax deduction in the same year will be big … and it'll hurt.

For example, let's take a look at a music store that's earned $350,000 of income before any rental pool depreciation. Let's say they bought $300,000 of new B&O instruments in 2013, did it again in 2014, and rented all of these instruments on a "rent-to-own" basis. Chart #1 (at right) shows the kind of depreciation deduction they can expect to get in 2013 and 2014, as well as the resulting tax effect. Because the retailer can make a Sec. 179 election in 2013 to expense the entire $300,000 purchase of B&O instruments, they can keep their 2013 tax liability to a manageable $17,500. But with the Sec. 179 deduction dramatically reduced and the bonus depreciation completely gone in 2014, their only option is to depreciate their B&O purchases over the three years allowed for rent-to-own contract pools. This results in a 2014 tax liability of $87,500 … which is $70,000 more in tax than the previous year.

Now let's look at Chart #2 which features numbers for the same music store, the same income and same rental pool purchases except these instruments are rented on "rent-to-rent" basis. Yes, the retailer can make the same Sec. 179 election in 2013 to expense the entire $300,000 purchase of B&O instruments. But again, with the Sec. 179 deduction dramatically reduced and the bonus depreciation completely gone in 2014, they're forced to depreciate their B&O purchases over the seven years required for rent-to-rent contract pools, thereby further limiting their deprecation deduction. This results in a 2014 tax liability of $107,500, which is $90,000 more in tax than the previous year.

Don't forget: With bigger rental pools comes bigger taxable income. With bigger taxable income comes higher tax brackets and proportionately bigger tax liabilities. This begs the question, "Is there anything that can be done to soften the forthcoming tax blow?" The answer is a resounding "yes," but it won't come in the typical form of some new tax deduction, or some overlooked tax strategy or loophole, or clever tax avoidance scheme (i.e. fraud). It'll come solely from some intelligent tax planning and — something many of you won't like — borrowing.

WHEN BORROWING IS A GOOD THING

I've been saying for years and remain steadfast in my belief that borrowing money is a good thing — as long as you're profitable and you manage your debt in a fiscally responsible manner. Borrowing money to pay taxes (which is presumably occurring because you're profitable) is, in my opinion, a good reason to borrow money. Even when profits are earned, they're rarely found sitting in the checking account. That's because most store owners take the cash generated by profits and use them to either buy more assets, pay down debt, or some combination of the two. This often results in little or no cash available to pay the taxes arising from those profits.

Since the tax due on net income is always far less than the net income itself, no business is going to damage its long-term profitability by paying taxes, but it can absolutely damage current cash flow by paying substantial or even unexpected tax liabilities. I'm confident most banks would be thrilled to lend money to a profitable business that simply needs some short-term borrowings to pay for a tax-related cash flow hiccup. But if the cash flow shortages stem more from paying for rental pool additions out of cash flow (even if invoices are "fall dated" from a vendor), long-term bank borrowings are a must. Remember: Never finance long-term assets (like computers, store fixtures, leasehold improvements and rental pools) with vital cash need for operations or even with short-term debt (like accounts payable or lines of credit). Always finance long-term assets with long-term debt, such as a five-year fully amortizing note.

CHART #1
AL'S MUSIC STORE
(RENT-TO-OWN CONTRACTS)

	2013	**2014**
Net Income Before Depreciation	$350,000	$350,000
Depreciation Deduction	(300,000)	(100,000)
NET INCOME	**$50,000**	**$250,000**
FEDERAL & STATE TAX (35%)	**$17,500**	**$87,500**

CHART #2
AL'S MUSIC STORE
(RENT-TO-RENT CONTRACTS)

	2013	**2014**
Net Income Before Depreciation	$350,000	$350,000
Depreciation Deduction	(300,000)	(42,857)
NET INCOME	**$50,000**	**$307,143**
FEDERAL & STATE TAX (35%)	**$17,500**	**$107,500**

"P" IS FOR PLANNING

Don't be caught off guard by this encumbering tax issue. Meet with your accountant to begin the process of forecasting rental pool additions and depletions, related depreciation, anticipated net income, resulting tax liabilities and their combined impact on cash flow for the 2014 tax year. Additionally, meet with your banker as soon as feasible, under the widely held belief that, "The time to get a banker is when you don't need one."

SUCK IT UP

In closing, for those of you who are about to start complaining, I have one bluntly insensitive but ultimately accurate retort: Be happy you had the benefit of huge depreciation deductions all these years, which saved you tens or even hundreds of thousands of dollars in taxes. You now get to pay the taxes, that would have been paid years ago, with today's cheaper deflated dollars — not to mention the earnings you made on all that tax money that was in your pocket instead of Uncle Sam's. Now don't you feel better? So, stop hating your accountant, say "thanks" to him or her for being on your side. **MI**

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