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Client Information Bulletin

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The Research Credit Is Back for Good *New law permanently extends tax break*

Like Arnold Schwarzenegger's character in *The Terminator*, the research credit is back. This valuable tax break, which had officially expired and been restored more than a dozen times in the past, was extended again by the Protecting Americans from Tax Hikes (PATH) Act, retroactive to the beginning of 2015. What's more, the credit has been made permanent, with certain modifications, by the new PATH Act.

Background: The research credit is generally equal to 20% of the amount of qualified research expenses for the year exceeding a base amount. The base amount is a fixed-base percentage (not to exceed 16%) of average annual receipts for the prior four years. In no case, however, can it amount to less than 50% of the annual qualified research expenses.

Alternatively, businesses can elect to use a simplified credit based on 14% of the amount by which qualified expenses exceed 50% of the average for the three previous tax years. Although an earlier version of the PATH Act included an increase in the 14% figure to 20%, this change ultimately was not included in the final law.

But the research credit is not automatic. The following three requirements must be met for the credit to be claimed.

1. The expense must qualify as a research and experimentation expenditure under Section 174 of the tax code. Such expenses include in-house wages and supplies attributable to qualified research, certain time-sharing costs for computer use in qualified research and 65% of contract research expenses (i.e., amounts paid to outside contractors in the United States for conducting qualified research).

2. The expense must relate to research undertaken for the purpose of discovering information that is technological in nature and the application of which is intended to be useful in developing a new or improved business component.

3. Substantially all of the activities of the research must constitute elements of a process of experimentation that relates to a new or improved function, performance, reliability or quality.

Note that the same or similar expenses may qualify for a research and experimentation deduction under Section 174. However, any Section 174 deduction must be reduced accordingly if you claim the research credit for the same expenses.

As with other tax extender provisions, the research credit officially expired after 2014. But now the PATH Act brings it back to life for

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2015 and thereafter. Depending on the circumstances, filing an amended return may be warranted.

Other new law changes: The PATH Act also enhances the research credit for certain companies for tax years beginning after 2015.

◆ A small business may claim the credit against alternative minimum tax (AMT) liability. For this purpose, a small business is one with an average of less than \$50 million of gross receipts over the prior three years.

◆ A startup company may annually claim up to \$250,000 of the credit against its FICA tax liability for up to five years. To qualify, the company must have less than \$5 million in gross receipts.

The research credit is an important tax incentive for businesses of all sizes. Coordinate your efforts to maximize the tax benefits that may be claimed under the new law. Your tax advisers can provide assistance.



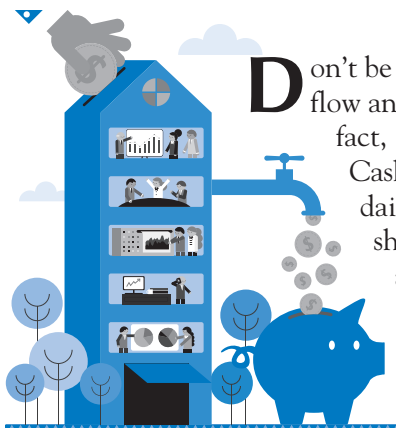
Be a Boss, Not a Best Friend

One of the hard things about being the boss is that it is impossible to be liked at all times. In fact, if you do not have to do or say some things that employees dislike, you are probably not doing your job very well. It is the nature of the employer–employee relationship.

Earn the trust, respect and loyalty of workers by acting like their boss and not a BFF. Do what is best for the business and not necessarily what will make you the most popular. In the end, the results will be rewarding.

Comparing Cash Flow to Business Profit

Understand and realize the key differences



Don't be fooled into thinking that cash flow and profit are the same thing. In fact, there are major differences. Cash flow is dynamic and moves daily, while profit is a snapshot of income and expenses at a specific point in time. Understanding this comparison, and acting upon it, can be significant for a small-business operation.

Background: Essentially, cash flow represents the difference in cash on hand from the beginning of an accounting period to the end. While cash comes “in” from sales, loan proceeds and investments, it also goes “out” to pay operating expenses, loans and asset acquisition. This can be reflected in a cash flow forecast.

Conversely, profit is the amount left over after business expenses have been paid. It is reflected on a profit and loss (P&L) statement.

Assuming you are using the cash method of accounting, you might have a relatively good handle on cash flow. But are you actually turning a profit? You could operate for long stretches without knowing the answer. Conversely, if your entire focus is on profit, as shown in

the P&L statement, you might run out of cash when you need it the most. Let's take a closer look.

The cash flow forecast records only actual cash transactions. It may be affected by a capital contribution by the business owners or investors, or the sale of assets. Although these events increase cash flow, they do not result in more profit. **Reason:** Income is not being generated from normal business activity. It is possible to be suffering a loss even if you have plenty of cash in the business account.

Similarly, if you buy expensive equipment or extensive inventory during the year, without enough sales, you could be showing a profit but still be in a dangerous cash flow position. Unlike a cash flow forecast, the P&L statement includes adjustments other than cash transactions. This includes the following items:

- ◆ depreciation expenses on capital assets such as equipment
- ◆ debts written down (e.g., on an uncollectible account receivable owed by a customer or client)
- ◆ assets sold at a loss or profit
- ◆ buildup of inventory

If you are not careful, you can easily confuse being busy with being profitable, especially when your business is

starting out. Remember that your profit is the amount left after all costs have been deducted. If you have not calculated sales prices correctly, a thriving business may, in fact, be operating at a loss. Despite a favorable cash flow, the P&L statement depicts a more accurate picture.

In other words, do not set prices without factoring in all the costs. Otherwise, you may end up operating at a

loss or at a small profit level that cannot be sustained over time.

In conclusion: This is only a brief overview, and there could be other complications. For example, timing is often an issue, or the accrual method of accounting is being used. Rely on your business advisers for assistance.

Four Basic Baskets of Interest Expenses

Divide interest into these categories

Are interest expenses deductible? The answer is a complicated “yes and no.” Essentially, it depends on the type of interest expense incurred. Although there are technically other types, interest expenses can be lumped into four main baskets for tax purposes.

1. Personal interest: If an interest expense does not fall into one of the other three categories, it is generally treated as personal interest. Simply put, personal interest is nondeductible. However, there is a key exception for interest paid on student loans. In brief, you can claim a limited deduction for interest paid for qualified higher education expenses—such as tuition, room and board, and books and fees—if the loan is in your name. The maximum deduction of \$2,500 is phased out for high-income taxpayers.

2. Mortgage interest: Generally, you can deduct “qualified residence interest” paid during the year. To qualify, you must be legally obligated to pay the mortgage, and the mortgage must be secured by a qualified home (i.e., your principal residence and one other home). The deduction limit depends on whether the debt is an acquisition debt or a home equity debt.

♦ **Acquisition debt:** This is a debt incurred to buy, build or improve a qualified home. The interest paid on up to \$1 million of acquisition debt is fully deductible.



♦ **Home equity debt:** Any other qualified debt, such as a home equity loan or line of credit, is treated as home equity debt. The interest paid on up to \$100,000 of home equity debt is fully deductible.

Unlike most other types of interest expenses, the interest on home equity debt may be deducted no matter how the loan proceeds are used. Home equity debt cannot exceed the fair market value of the home on the last day of the year reduced by the outstanding acquisition debt.

3. Investment interest: If you borrow funds to buy property held for investment purposes (e.g., securities or real estate), the interest paid on the loan is treated as investment interest. The amount of investment interest you can deduct is generally limited to the amount of your net investment income for the year. Any excess is carried over to the next year.

Net investment income includes gross income from property held for investment such as interest, annuities and royalties. It does not include capital gains and qualified dividends eligible for tax-favored treatment. The maximum tax rate for long-term capital gain and qualified dividends is generally 15% (20% for some high-income taxpayers) as opposed to ordinary income taxed as high as 39.6%. **Note:** You can elect to include long-term capital gain and qualified dividends as net investment income, if you are willing to forfeit the preferential tax rate.

4. Business interest: The interest incurred in any trade or business, or in the production of rental or royalty income, is fully deductible. Unlike the deductions for mortgage interest and investment interest, there are no limits on deductible amounts.

This is only a brief summary of the main rules in this complex area. Obtain professional advice for your personal situation.



Give Us A Call!

Do you have any questions or comments about **Client Information Bulletin** or your individual situation? Please do not hesitate to contact our office. We would be glad to serve you in any way we can.



Six Hiring Mistakes to Avoid

Create a blueprint for interviews

Are you hiring someone to join your business team? A successful new hire is one who meets the necessary requirements, fits in well with other team members and brings value to the business. When interviewing candidates, avoid six common mistakes that often plague business managers.

1. Establish your objectives. How can you find the right person for the job if you do not know what you are looking for? From the outset, it is important to identify the qualifications, skills and experience needed for the position. Set in writing the specific job requirements and characteristics you desire (e.g., a salesperson may have to be outgoing).

2. Don't automatically hire friends or family. When you begin the search, a friend or family member may immediately pop into your mind. But you should not jump at the opportunity just because it is convenient or fulfills a perceived obligation. If things do not work out, it could cause a serious rift in a friendship or within the family. This is not to say hiring friends or family is strictly prohibited, but proceed with caution.

3. Ask the right questions; avoid the wrong ones. The interviewing process is also fraught with legal perils. Asking questions about a person's age, racial or ethnic background, religion, political affiliation and other personal matters can make your firm vulnerable to a discrimination lawsuit. Focus on questions directly related

to the job at hand. If you are unsure about raising an issue, simply don't do it.

4. Don't make snap judgments: If you hit it off immediately with a prospective job candidate, or the person looks perfect "on paper," you may be inclined to trust your first impression. But there is more to the hiring process than the initial interaction. Go through the paces to ensure that the person truly measures up to your requirements. Consider why this person might not be the best person for the job despite first appearances.

5. Do background checks. Even after you have made your choice, the process is far from over. Conduct a background check on the candidate without crossing legal boundaries. Also, contact the references provided by the prospective hire. If he or she furnishes a contact for a disgruntled ex-supervisor, it should raise suspicions.

6. Define company policy. Create a definitive hiring policy and explain the rules in your company manual. Not only does this provide a blueprint to follow, it can offer some protection against legal challenges, especially if the interviewers stick to the script. The policy should reflect the principles outlined above. Conversely, if policies are vague, open-ended or nonexistent, it could lead to trouble.

A thriving business needs to add new hires to continue its growth. Take the time to choose wisely.

Facts and Figures

Timely points of particular interest

➔**Casual Fridays**—With the summer arriving soon, your company might institute a casual Fridays policy. Generally, this means you do not have to dress as formally on Friday as you do the rest of the workweek. For instance, in an office where suits and dresses are required, employees might wear jeans. But employees should not go overboard. Depending on the business, cutoff shorts and flip-flops may not be appropriate.

➔**Section 179 Limits**—Under the PATH Act, the maximum \$500,000 Section 179 deduction and \$2 million phaseout thresholds are restored, retroactive to 2015 and made permanent with inflation indexing starting in 2016. Due to low inflation, the IRS has announced that the maximum deduction for 2016 remains at \$500,000, while the phaseout threshold is bumped to \$2,010,000.

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