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Selling, General, and Administrative Costs
Investment or Overhead?

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Selling, general, and administrative (SG&A) costs are generally referred to as overhead or the operating costs of a business. Carefully evaluating these costs can help companies improve their bottom lines or, at least, be more effective in the overall utilization of their capital.

The "Great Recession" offered a silver lining: it forced business owners to find ways to reduce costs and be more productive with fewer resources. Companies cut costs in every area, including SG&A expenses, and many remained profitable in the face of reduced demand for their products and services. As companies found ways to do more with less people, one unfortunate effect was the high unemployment that we still see today. However, there was also a significant rise in innovation and productivity.

As business has gradually returned to pre-recession levels, there has been a natural tendency for companies to pay less attention to controlling their SG&A costs. However, this could be a missed opportunity. One could argue that some SG&A costs should really be considered investments instead of overhead. Evaluate each cost carefully to determine whether it is an investment or overhead that does not add value. Then, focus on eliminating or minimizing as much of the overhead as possible.

Companies may reach different conclusions about what is an investment versus what is overhead. For example, office space needs for some service businesses are diminishing thanks to technological advances that allow more employees to work from home. For a manufacturing business, though, building space and the efficient use of that space would likely be viewed as an investment.

Here are five more SG&A expense categories to evaluate.

Sales

When business slows, selling costs are often one area that is cut when, perhaps, the opposite should be the case. Sales are the lifeblood of all businesses and cutting back in this area can be a mistake. However, sales costs are often not thoroughly evaluated to measure their effectiveness. The same ads are purchased, the same trade shows are attended, and the same customers are called without evaluating whether these strategies are leading to increased or new sales.

While selling **activities** for many companies can be considered an investment, there are many selling **costs** that are really overhead and should be measured, evaluated, and in some cases eliminated. For example, websites and social media may be better investments than elaborate magazine ads for some companies.

Insurance

Insurance is a significant investment decision for most businesses. While it may be difficult to view insurance as an investment, companies need to take risk management more seriously in an increasingly complex and litigious business environment. There are many types of insurance coverage available and it seems as though you can insure just about every business risk imaginable. Evaluate cost vs. benefit carefully and do not take this decision lightly.

Information Technology

Information technology costs are clearly investments. Most businesses cannot operate efficiently or effectively without solid information technology solutions. Investments in email, website development and maintenance, social networking, accounting, contact management, and enterprise resource planning are critical to success in today's business environment. Carefully evaluate your needs and solutions to ensure you are spending wisely. Missteps can be extremely costly.

Professional Fees

Professional fees are one area that will likely be viewed differently by each company. Attorneys, accountants, and other professional consultants should be considered investments. These professionals can offer considerable expertise and value for your business. Smaller, less complex businesses may find they do not need sophisticated professional advice. However, beware of being penny wise and pound foolish. Think carefully about what advice or services you truly need and do not shy away from making a sound investment.

Travel and Supplies

Items such as office stationary and supplies, travel and entertainment, telephone, and utilities are usually necessities but, for the most part, are also non-value added costs for most companies. These costs should be closely evaluated and monitored for ways to reduce, minimize, or eliminate them. If these costs are neither a necessity nor adding value, give serious consideration to eliminating them.

Do not let your SG&A costs get out of control when times are good. Do an investment vs. overhead analysis of these costs and reduce or eliminate those that are not adding value in your business. **LE**

4 Steps to Minimize the New Net Investment Income Tax

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The new Net Investment Income Tax (NIIT) was first introduced into our vocabulary in 2010 with the passage of the Affordable Care Act. With the challenges of this new law behind us, the tax is here to stay and is effective as of January 1, 2013.

To summarize it briefly, the new NIIT is an additional 3.8 percent Medicare surtax on your net investment income. This is in addition to the regular income tax you pay on interest, dividends, capital gains, annuities, royalties, rents, and passive income. The tax applies to net investment income of single filers with modified adjusted gross income (AGI) above $200,000 and of couples with AGI over $250,000. Married filing separately has a $125,000 threshold. Modified AGI is AGI plus tax free foreign earned income. The tax is due on the smaller of net investment income or the excess of modified AGI over the threshold.

The biggest contributors to this tax will be small business owners that operate their businesses as pass-through entities (i.e. S-Corporations and Partnership). Their allocable share of income is reported on their individual tax return, even though the income may or may not be distributed to them. This puts small business owners at a disadvantage, as this will most likely put them over the reporting threshold for the NIIT. The result is a potential maximum tax rate on their rental, interest, and passive income at 43.4 percent and long-term capital gains and dividends at 23.8 percent.

What steps can you take to minimize the impact of this surtax? While the answer ultimately depends on your personal tax situation, there are four areas for all taxpayers to consider when facing this new tax.

STEP 1
Try to keep your income below the AGI thresholds.

Take advantage of tax-deferred strategies and certain deductions to lower your AGI. The most common is making sure you are maximizing all your retirement contributions. If you are in a high-deductible health plan, make sure you are contributing the maximum to the plan. If you have large gains in the stock market, look to offset those gains with any losses in your portfolio. If you are planning to sell any real estate, a like-kind exchange may be the perfect opportunity to defer gain into the future.

STEP 2
Evaluate your investment choices.

When reviewing your investment portfolio, consider investing in growth stocks. The appreciation in these investments is not taxable for the NIIT until you actually sell the stocks. Also, look for tax-exempt interest and bonds since the interest is never taxable for NIIT purposes.

STEP 3
Look for deductions related to your investments.

Expenses related to the generation of investment income can be applied against the investment income to minimize the tax. These include investment advisory fees and state taxes you pay on your taxable investment income, investment interest expense, and expenses related to your rental income activity. It is also important to note that the interest income from shareholder loans to their pass-through entity's business can be offset by their allocable share of interest expense incurred at the entity level.

STEP 4
Evaluate your passive activities.

Finally, review your level of involvement in all of your business activities to determine if you are considered active by definition of the Internal Revenue Code (i.e. more than 500 hours). If not, evaluate increasing your level of involvement to meet this standard. Also, look to make an election on your 2013 return to group your businesses together to meet this standard to avoid the NIIT. Keep in mind that rental income generated from renting to your business is excluded from this tax.

As this new tax begins to evolve and some of the challenges begin to come to light, you should understand how this could impact your personal situation. The roadmap above can assist in planning to minimize the tax on your investment income. **LE**

The Latest Developments in Private Company Accounting

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The Private Company Council (PCC) has two main responsibilities:

- Work jointly with the Financial Accounting Standards Board (FASB) to establish criteria that determine whether and when alternatives within U.S. Generally Accepted Accounting Principles (US GAAP) are warranted.
- Serve as an advisor to the FASB on the appropriate treatment for private companies for items on the FASB's technical agenda.

During the last several months, the rapid pace of the PCC's agenda has progressed further.

Private Company Decision-Making Framework

On December 23, 2013, the FASB and PCC issued the *Private Company Decision-Making Framework: A Guide for Evaluating Financial Accounting and Reporting for Private Companies.* This framework will be used by the FASB and PCC in making user-relevance and cost-benefit evaluations for private companies aimed at proposing alternative treatments under US GAAP. An important source of input in developing this framework was the identification of key differences between public and private companies, such as:

- Number of primary users and their access to management
- Investment strategies of primary users
- Ownership and capital structure
- Accounting resources
- Learning about new financial reporting guidance

In addition, the framework identified five crucial areas where accounting guidance might differ:

- Recognition and measurement
- Disclosures
- Presentation
- Effective date
- Transition method

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The expectation is that this framework will help identify cost-effective alternatives for private companies and also benefit the standard setting activities for other organizations.

FASB Endorsed PCC Alternatives

On November 25, 2013, the FASB endorsed two PCC alternatives, followed by the release of two Accounting Standards Updates (ASU) in January 2014:

- FASB ASU No. 2014-02, *Accounting for Goodwill*, (previously PCC Issue No. 13-01B) allows a private company to amortize goodwill over 10 years, or shorter, if appropriate. Furthermore, a private company can make an accounting policy decision to perform its impairment testing at the entity-level or the reporting unit level. Previously under US GAAP, impairment testing was always performed at the reporting unit level. The alternative would be applied prospectively to any new or existing goodwill.
- FASB ASU No. 2014-03, *Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps—Simplified Hedge Accounting Approach*, (previously PCC Issue No. 13-03A) allows a private company a practical expedient to obtain cash flow hedge accounting treatment for swaps that meet certain conditions. This approach assumes the hedge is fully effective, allows a private company to complete its hedge documentation up until its financial statements are issued, rather than immediately, and allows for the recording of the swap at settlement value instead of fair value. The alternative would be applied on either a modified retrospective or full retrospective basis, with an election made on a swap-by-swap basis.

Both of the above are effective for fiscal years beginning after December 31, 2014, with early adoption permitted. Companies should also review the FASB's December 2013 issuance of ASU No. 2013-12, *Definition of a Public Business Entity*, which will have an impact on determining which entities are eligible to apply the alternatives, as well as future alternatives approved by the FASB and PCC.

Other Projects Currently on the PCC Agenda

As of its January 28, 2014 meeting, the PCC has two other projects that are on the drawing board or for which research is currently being conducted.

- An alternative to accounting for identifiable intangible assets in a business combination.
- An alternative for applying variable interest entity (VIE) guidance to common control leasing arrangements, which could eliminate the consolidation requirement for private companies.

Private and public companies should monitor the PCC's technical agenda as modifications to US GAAP for private companies may result in modifications of standards applied to other entities. All companies should benefit from ways to address concerns over cost, complexity, and relevance.**LE**

The expectation is that [the private company decision-making framework] will help identify cost-effective alternatives for private companies and also benefit the standard setting activities for other organizations.

New Safe Harbor for Home Office Deductions

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There is great news for taxpayers who generally have modest home office-related business deductions. For tax years beginning on or after January 1, 2013, the IRS has established a new, simplified safe harbor method for individuals who claim a deduction for the use of a home office. The safe harbor method does not change the rules for when deductions for a home office are allowed. It simply changes the method of calculating the deduction.

As a reminder, a home office deduction for a self-employed individual is generally allowed if part of the home is used regularly and exclusively as a principal place of business or as a place to meet or deal with customers or clients in the ordinary course of business. Employees of the business must further show that the home office is for the convenience of their employer. The home office deduction is limited to the gross income of the business activity reduced by the allocable portion of the related home expenses, such as mortgage interest, real estate taxes, and other business expenses. Deductions that are disallowed due to the limitation are carried forward to the following year.

The new safe harbor method allows an eligible taxpayer to deduct $5.00 per square foot of space used for qualified business use, up to a maximum of 300 square feet. Thus, the maximum annual safe harbor is $1,500. Under this method, there is no requirement to keep any documentation of expenses as long as the taxpayer qualifies for a home office deduction. For taxpayers who itemize deductions, items such as qualified home mortgage interest and real estate taxes are fully deductible on schedule A.

Under the safe harbor method, you cannot write off any depreciation for the year since depreciation under this method is deemed to be zero. The safe harbor method is also subject to the business income limitation. For example, if your gross income from the business activity is $1,100 and you qualify for the maximum $1,500, you will be limited to $1,100 and the unused deduction cannot be carried over.

The safe harbor method is an annual election. As such, a taxpayer can choose between the safe harbor method and the actual expense method for any given year. For example, a taxpayer can use the safe harbor method in 2013 and the actual expense method in 2014. The election is made by using the safe harbor calculation on a timely-filed original tax return for the year. Once the election is made, it is irrevocable for that particular year.

The new safe harbor election may not be for everyone. If you have substantial home office deductions, the actual expense method may result in a deduction that is far greater than the maximum $1,500 allowed under the safe harbor method. However, if your expenses are modest and you do not want to keep records of your expenses, the safe harbor method works for you. **LE** leading edge alliance

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