CASH FLOW IS EVERYTHING

Cash: The green stuff everyone in business lusts for. They need to or they won't be around long. It comes from many different sources. Some are good and some not so good, depending on the circumstances and the timing. We get many questions regarding cash flow every month and how to manage it better.

One source of cash comes from existing savings you may have accumulated over time. The cash may have been generated from wages, investments, etc. This cash could be in your checking or savings account. This is cash which may be your nest egg for the future so you are being very careful with it, or need to be. Failure to do so may put your future plans and retirement in jeopardy.

Another form of cash flow is a loan. The loan can be from a bank, financial institution, family, friends, an investor, etc. The bad thing about loans is someone always expects you to repay them sometime in the future and to normally generate a return on the monies loaned to you. These loans may be collateralized by inventory, receivables, fixed assets, etc. The problem with this is if you happen to default, your precious assets you pledged can be taken by the lender to satisfy the debt. They may even chase you for any deficiencies if the collateral isn't enough to satisfy the outstanding loan balance.

You could also inherit cash from someone. The nice thing about this is it is normally tax free, depending on the circumstances. You don't have to repay it and there may not be any restrictions on its use. The proceeds from a life insurance policy on someone who named you as a beneficiary of the policy can be a source of cash. Normally this cash is also tax free also and doesn't have many restrictions on its use.

Cash is normally the most important asset in your business. Your bank balance may be low on any certain day, but the amount of activity in the account could be extremely high, generating large deposits and disbursements each day. It is the livelihood of your business and must be monitored each and every day.

Sooner or later you will need to turn your assets into cash. This will help you pay your bills, wages, distributions, payroll and sales taxes, loans, etc. You can normally get away with not paying some of the items above for a short time, but sooner or later it will catch up with you. It is not a pleasant sight to see a company without adequate cash flow to operate their business effectively.

Many times the controller of the company uses up most of the day trying to find enough cash so they can release some checks to vendors or pay off vehicle floor plan. This to me seems like a gigantic waste of time. This doesn't help you become more profitable and causes quite a high stress level in the accounting office. It may also worry you each day to the point where you don't have time to properly operate your business. This can create a very unhealthy environment for your business.

How can you get out of this vicious cycle you have discovered yourself fighting each day? It probably won't be easy.

Normally cash flow increases over time in most businesses when sales and gross profits increase. It can also increase if your cost of sales or expenses are decreased when everything else remains constant. This is where you have to analyze your business to find the best and quickest way to increase cash flow. In certain businesses, increasing sales faster than the cash flow normally results in a higher receivable balances, which uses up cash. It may make sense to pace your sales increase to give your cash flow time to catch up and remain in sync with it.

The best place to start is to look at your most liquid assets and the current market situation on liquidating them. If it is inventory, you may have sources which will buy it from you and pay you immediately. You may also increase your sales and gross profits to generate cash. If it is receivables, you may have to make phone calls to your customers who are past due to nudge them to pay you.

Another thing you should be doing is projecting what your cash flow needs are in advance of needing the cash. This will always make things go much easier. It allows you time to approach your lender for an increase, sell excess inventory, collect delinquent receivables or review your personal assets to see where cash could be generated from and have it on hand to make the payments you need to timely. The best thing is to give yourself adequate notice of when and how much cash you will need so your business is not crippled and struggles to operate every day.

Good luck on managing your cash flow. If you do nothing else each day, spend a few minutes with your cash each day and know where you are at, and where you can go with it.

TAX TIP

Sorting Out NII Tax Liability on Rental Income

The intent behind the 3.8 percent net investment income (NII) tax enacted in 2010 was principally to impose a surtax on unearned, passive-type income. The statutory language of the law, in addition to the lengthy proposed regulations issued to further explain this new tax, unfortunately has not made what had been a straightforward goal into a complex maze of rules for many taxpayers and their advisors. The complexity has stemmed largely from an effort by both Congress and the IRS to prevent "loopholes" on the one hand while not being "over-inclusive" on the other. Among the areas of particular concern that have developed over the past year has been the determination of when rental income is subject to the NII tax

Applicable to individuals and estates and trusts, the NII tax is effective for tax years beginning after December 31, 2012. While proposed regulations were published as "reliance regulations," final regulations are expected to be released in 2013, however, time is growing short for the 2014 filing season. While we hope that the final regulations may end the confusion in certain areas, we are not overly optimistic.

Net Investment Income

The computation of the tax on net investment income necessarily requires determining the taxpayer's "net investment income". In an attempt to simplify the language, which uses double negatives and non-intuitive terms, the following streamlined definition has been suggested, computing "net investment income" as:
The Sum of...

- Gross income from interest, dividends, annuities, royalties, and rents not derived in the ordinary course of a trade or business,
- Gross income derived from a trade or business that is either (a) a passive activity (within the meaning of with respect to the taxpayer or (b) a trade or business of trading in financial instruments or commodities, *and*
- Net gain (to the extent taken into account in computing taxable income) attributable to the disposition of any property other than property held in a trade or business.

Rental Income as a Trade or Business

Determining whether rental income or gain is "derived in the ordinary course of a trade of business" is a key element in determining whether rental income is subject to NII tax. If rental income or gain is not derived in the ordinary course of a trade or business, it is NII, irrespective of whether the activity is passive or active as to the taxpayer. There is no single test or tests for determining whether a rental activity is a "trade or business." However, there are legions of cases that have addressed this "facts and circumstances" determination over the years. Clearly, the more duties, responsibilities, and obligations a lessor has under the lease, the more likely the rental activity will be considered a trade or business.

With respect to rental income and its exposure to the NII tax by way of the passive activity loss (PAL) rules, two tests have been suggested:

- "If the rents are not derived in the ordinary course of a trade or business, then the rents constitute net investment income.
- "If the rents are derived in the ordinary course of a trade or business, then the rents constitute income from a passive activity included in net investment income unless IRC Section 469 or its regulations exclude the rents from passive income.

Real Estate Professional Exception

The Code provides an exception for taxpayers in real property businesses (i.e., the real estate professional exception), under which the passive activity classification of rental real estate does not apply. A taxpayer's rental real estate activities in which he or she materially participates are not subject to limitation under the passive loss rules if the taxpayer performs more than (1) half of the personal services he performs in trades or businesses in the tax year in real property trades or businesses, in which he materially participates; and (2) 750 hours of services during the tax year in real property trades or businesses in which he or she materially participates.

If a taxpayer satisfying this two-pronged threshold test materially participates in a rental real estate activity that is a trade or business, then any net income should be non-passive under both the PAL rules and the NII tax. If, however the rental real estate activity does not rise to the level of a trade or business, then irrespective of material participation (involvement that is regular, continuous and substantial), the rental income from that activity would apparently be considered NII even for a qualifying real estate professional—even if not treated as passive income under its material participation test. This issue is expected to be addressed more directly in final regulations.

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Until final regulations are issued which will clarify many of the above issues you should discuss your specific situation with your ATA representative.