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June 2014

Trends & Developments

BUSINESS PRACTICES

DEBT...It's Not Always Just a Four-Letter Word

By Allen Wilen, CPA

The media would have everyone believe that debt is a bad thing. Like anything, too much of it is obviously not a good thing. It is analogous to sun and water for farmers. They need sun and water to maximize their crop at harvest time, but too much sun or too much water and the crop fails. It is this same fine balance between debt and equity that businesses need to grow and maximize profits to owners.

This can be best displayed with an example that shows how debt can be used to maximize profitability:

EXAMPLE

Consider Business A and Business B. Both businesses are in the same industry and have similar capital structures.

John, the owner of Business A, is very conservative and refuses to take on debt to grow his business (which is currently earning $15,000 per month in profits). Thus, he will wait to expand his inventory product line until he can pay for it and the new equipment needed to manufacture it until he has the necessary excess cash on hand, which will be in two years.

Bob, the principal of Business B, is willing to use debt to grow his business because he feels the opportunity exists in the marketplace today. He reaches out to his local banker to help him finance the growth. The bank offers him the $190,000 he needs at 8% for the equipment. The bank loan amortizes over a 5-year period. As a result of the investment in the new equipment, monthly profits can increase from $15,000 per month to $25,000 per month.

THE RESULT

Total Profits at the End of Two Years

BUSINESS A

$15,000 per month x 24 months = $360,000

BUSINESS B

$15,000 profit/month x 24 months = $360,000
Plus: Incremental Profit on new sales
$10,000 profit/month x 24 months = $240,000

Less: Interest on Bank Debt Year 1 and Principal Paydown Year 1
$190,000 Loan x 8% = $15,200 in Interest for Year 1
Principal Payment (assuming 5 years amortization) — $38,000

Less: Interest on Year 2 and Principal Payment Year 2
152,000 ($190,000-$38,000) Loan x 8% = $12,160 in Interest for Year 1
Principal Payment (assuming 5 years amortization) — $38,000.

SUMMARY

	Business A	Business B
Profit from Operations for Year 1 and 2	$360,000	$360,000
Incremental Profits		$240,000
Interest and Principal Year 1		($53,200)
Interest and Principal Year 2		($50,160)
End of Year 2 Profits	**$360,000**	**$496,640**

Using this very simplistic example, Bob's use of debt in a proper manner yielded him significantly greater profitability in the short term and there will be many more years of increased profitability as a result of his decision. (Someone reading this will say that I didn't take into account the cost of operation of the maintenance on the equipment, but this analysis also does not take into account the tax benefits of the depreciation and interest expense coupled with the fact that the machinery may last far more than the five years over which it is being amortized.) This is a perfect example of how debt can work to increase profitability.

If you look at successful businesses, almost all of them used some form of Debt to finance and grow their business. In today's highly complex economy, business owners need to invest in the new equipment and technology to stay competitive. Failing to invest in a business is one of the quickest ways to destroy the value of the going concern a business owner has built over the years.

Debt comes in many forms and styles. I am sure many business owners have been approached by lenders who use terms like "Cash Flow Lender," "Asset Based Lender," "Factor," and/or "Purchase Order Finance;" the list goes on and on. Not all debt is the same and not all debt fits every situation. The professionals at EisnerAmper can assist you in identifying what type of debt is best in your specific business situation.

Remember, good debt is used to grow your business. Resist the temptation to use debt to cover losses or to give your key employees additional compensation, including yourself. ■

If you'd like to find out more, please contact Allen Wilen at 732.243.7386 or allen.wilen@eisneramper.com.

INTERNATIONAL TAXATION

How Does FATCA Impact You?

By Chaya Siegfried, CPA and Harold Adrion, CPA

The Foreign Account Tax Compliance Act (FATCA) is a complex withholding regime that is aimed at identifying U.S. people who may not have been reporting foreign income or foreign accounts. Since foreign financial institutions are the primary vehicle through which foreign financial accounts are maintained, they are the main focus of the FATCA legislation. However, the broad scope of the FATCA legislation encompasses all U.S. businesses that make payments to non-U.S. entities or individuals.

IMPACT ON NON-FINANCIAL BUSINESSES

While U.S. non-financial institutions do not have the level of FATCA-related issues that foreign and U.S. financial institutions have, they will have significant challenges in documenting the status of foreign recipients of payments and implementing IT systems to track the documentation received from foreign payees and correlate it with payments.

Many U.S. non-financial institutions have some knowledge of the documentation required with respect to payment of fixed, determinate, annual or periodical payments (FDAP) to non-U.S. persons under Chapter 3 of the Internal Revenue Code (IRC). In brief, a W-8 BEN is obtained for foreign payee and a W-9 is obtained for U.S. payees.

"Documentation" for FATCA purposes (Chapter 4 of the IRC) generally means one of the new Forms W-8 (or for a U.S. payee when required, the old, familiar Form W-9). With the recent release of the W-8BEN-E form, there are currently five Forms W-8 for use simultaneously under chapters 3 and 4. The addition of FATCA status and the kinds of payment relevant to FATCA have dramatically increased the length, complexity, and requirement of U.S. tax knowledge to understand and complete at least two of these: the W-8BEN-E (to be used by legal entities that beneficially own the payment being made) and the W-8IMY (to be used by various kinds of intermediary,

How Does FATCA Impact You?

transparent entity, or other recipients that are not a beneficial owner). The FATCA regulations increase the importance of receiving the correct form, correctly filled out. The regulations have also broadened the standard under which a withholding agent is considered to have reason to know that a Form W-8 is unreliable or incorrect, by specifying various factors that could provide such a reason.

The IRS recently released the revised Form 1042. This Form has significant changes to reflect the new withholding rules under FATCA. The IRS has broadened the circumstances under which the form must be filed, and expanded the form from one page to two.

Because the U.S. payor is ultimately liable for delinquent withholding or income tax with respect to payments it made, failure to obtain the proper documentation can result in penalties of up to 60% of amounts paid.

Recently the IRS issued Notice 2014-33 that provides a favorable transition period. According to the Notice, the years 2014 and 2015 will be regarded as a "transition period" for purposes of IRS enforcement and administration of FATCA due diligence, reporting, and withholding provisions and other related provisions, to the extent those rules were modified by temporary FATCA coordination regulations released in February 2014.

With respect to this transition period, the IRS "will take into account" the extent to which a foreign financial institution, other foreign entity, or U.S. or non-U.S. withholding agent has made "good faith efforts" to comply with the requirements of the FATCA regulations and the temporary coordination regulations.

FATCA is part of an overall increased effort by the U.S. Department of Justice to address potential tax evasion through offshore accounts and investments. The IRS continues to encourage compliance with the many foreign account and investment reporting requirements through the Offshore Voluntary Compliance Initiative.

WHAT SHOULD NON-FINANCIAL COMPANIES BE DOING

- Identify all foreign payees
- Identify various departments and U.S. subsidiaries that make payments to foreign recipients.
- Obtain new Form W-8BEN-E from all foreign payees.
- Identify intercompany payee payments that are likely being made for which documentation is required.
- Update IT systems to incorporate new W-8s

Examples of departments that have control over payments for foreign recipients include: treasurer's office, accounts payable, general counsel, and property and management.

Some payees may be reluctant to provide new W-8BEN-E — discussion will have to take place as to why the new E-8BEN-E is needed. ■

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COMPLIANCE SERVICES

The Value of a Mock SEC Inspection

By Gary Swiman, CPA and Carmine Angone

Since the enactment of the Dodd Frank Wall Street Reform and Consumer Protection Act replaced the private fund exemption under the Investment Advisers Act of 1940 (the "Advisers Act"), requiring investment advisers with $150,000,000 in private fund assets and $100,000,000 for all other advisers to register with the SEC, it seems as though a day does not go by without reading or hearing about a private fund manager being examined by the SEC and cited for numerous compliance failures.

This often results in the private fund adviser hiring an outside consulting firm to remediate the SEC's findings and, in more serious situations, paying a fine and retaining the consulting firm to monitor firm activity for a period of time. The downside is the harmful impact that results from both the negative press release and the adviser's requirement to disclose the event in all of its disclosures documents, such as Form ADV, responses to DDQs and RFPs, etc. This can be very costly both from a monetary perspective and the loss of a potential investor into one of the managed funds due to the required disclosures. In addition, it's a very time-consuming process that keeps the adviser from doing what it does best, which is manage client assets.

It is also easily avoidable.

The best approach to see if your compliance program is up to SEC and industry standards is to engage an independent consulting firm with the requisite expertise to conduct a mock SEC inspection. I would also like to note that this goes hand-in-hand with recent comments made by SEC Commissioner Daniel Gallagher to permit private third parties to examine registered advisers, as the SEC is not able to receive federal funding to hire the requisite number of examiners to adequately implement the SEC's Office of Compliance Inspections and Examination ("OCIE") National Examination Program objectives. While there has been no definitive decision made yet, Mary Jo White, SEC Chairwoman, did not object to the idea of using third parties or a self-regulatory organization, such as FINRA, to do the work of the SEC.

WHAT IS A MOCK INSPECTION AND HOW DOES IT WORK?

A mock inspection involves examining the operations of the financial services firm by looking at the internal controls that are designed to reasonably ensure compliance with the firm's regulatory responsibilities and performing similar functions as the SEC would during an examination.

How it works is an independent consultant initiates the process by selecting one of the first-day letters used by the SEC in the past for the specific type of financial services advisers (such as private capital, hedge fund, fund of funds, hedge fund of funds, mutual fund, ETF, or wealth management and managed account platform managers (sponsored and unsponsored), etc.). The purpose of a first-day letter is to notify the adviser of the timing of the examination (in the case of the SEC) and to request certain documentation required to be maintained, in accordance with SEC record retention rules and regulations, based on the advisory services provided and type of client(s). The next step in the process is to interview key employees in critical operations, such as portfolio managers, traders, CCO, CFO, CEO, COO, marketing, etc. This will provide useful insight into a number of different areas, such as:

- Whether critical employees, some with supervisory oversight (which has larger regulatory failure to supervise implications), understand the firm's compliance procedures and corresponding controls. If employees do not understand the firm's procedures,

The Value of a Mock SEC Inspection *(continued)*

they are more than likely not following those procedures. This may suggest inadequate or no firm-wide training has occurred or employees are simply not complying with procedures,

- Uncovering potential new conflicts of interest not previously identified either because employees are engaging in activity not contemplated by the procedures or due to a change in business objectives, operations or law,
- Whether the procedures are reasonably designed to detect, prevent and remediate (as necessary) actual and potential conflict of interest, as required under law.

At this point in the mock engagement, the consultant would perform forensic testing by selecting a representative sample of data in key high risk areas, such as:

- Employee personal and insider trading,
- Firm-wide trading activity (both client and proprietary) for best execution and potential conflicts of interest,
- Adherence to investment guidelines and restrictions (including client, statutory and self-imposed),
- Soft dollar arrangements (third-party and proprietary),
- Use of research networks,
- Expenses charged to private funds and portfolio companies of private capital funds compared to fund disclosure documents,
- Third-party solicitors,
- Consistency of disclosures,
- Client assets safeguards,
- Privacy of client data, and
- Cyber security, including vendors depending on the type of information retained by the vendor.

These are just some the common high risk areas to test; this is not an exhaustive list as the type of investment vehicle managed will drive the testing.

The last step in the inspection process is to compare firm activities to procedures and applicable federal securities laws to ensure the compliance procedures address all areas of governing law. The compliance program rules under the Advisers Act (Rule 206(4)-7) and Investment Company Act of 1940 (Rule 38a-1) for registered funds require compliance programs to address, at least, all the applicable rules and regulations under the Advisers Act and for registered funds all applicable federal securities laws.

Upon the conclusion of the analysis, a gap analysis is provided to senior management with corresponding alternative recommendations on how to remediate. The independent consultant performing the engagement often assists in the implementation process of senior management approved recommendations to reasonably ensure they are implemented as intended.

WHAT ARE THE BENEFITS OF THE MOCK ENGAGEMENT?

Our experience has shown that going through this process is beneficial to financial services firms because it prepares them for when the SEC eventually sends that first-day letter. This process is very instrumental in assisting advisers in fulfilling the requirements under the SEC compliance program rules to annually evaluate their compliance programs for adequacy, accuracy, and effectiveness of implementation of procedures. A mock inspection can also be of value to newly registered advisers to ensure they are prepared for when the SEC performs a different type of limited review applicable to new advisers or a "presence examination." The SEC performs a presence examination to determine whether the registered adviser had a compliance program already in place and fully tested prior to submitting a request for registration.

It is important to note that it is more likely the SEC will view advisers that obtain an "independent" evaluation of their program and advisory operations as part of an ongoing process to establish a "nothing-to-hide" culture of compliance from the top down. ■

Questions? Please contact Gary Swiman (212.891.4057,gary.swiman@eisneramper.com) or Carmine Angone (212.891.6095, carmine.angone@eisneramper.com) of EisnerAmper Compliance and Regulatory Services (CARS) LLC for more information.

EMPLOYEE BENEFITS

Three Common Considerations of Employee Benefit Plan Sponsors in 2014

By Diane Wasser, CPA

1	Timing of Employer Match Contributions
2	Awareness of Rollovers
3	Relief from DB Plan Obligations

1. TAKING A CLOSE, BUT DIFFICULT, LOOK AT EMPLOYER MATCHING CONTRIBUTIONS MADE TO DEFINED CONTRIBUTION PLANS.

What do IBM and AOL have in common with each other and many other companies that sponsor defined contribution employee benefit plans? They recently changed the frequency of the deposit of their 401(k) plan employer match. Such a move causes a rumble from the active plan participants.

As employers strive to balance the cost of doing business, rising health care costs and employee benefits, many have changed the timing of the deposit of the Company's matching contribution into their 401(k) plan. Assuming the plan document properly reflects such a provision, there is nothing in the Employee Retirement Income Security Act ("ERISA") requiring an employer to contribute the matching contribution with each payroll throughout the year. The only requirement is to deposit the matching contribution into the plan prior to the last day of the following plan year. However, in order to deduct the contribution for tax purposes in the year for which the match is allocated, the employer must make the deposit into the plan prior to the extended due date of the employer's corporate tax return.

By changing the timing of the employer match contribution, IBM and AOL are able to reduce the administrative burden of monthly remittances and typically, although not required, most plans require plan participants to be employed on the last day of the plan year to receive the annual match. Thus, by making only an annual match contribution, a plan sponsor can save significant contribution dollars when no contribution is required to be made for those participants who left the company during the year.

From an employee stand-point, having matching contributions submitted throughout the year is preferable for two reasons: 1) if the employee leaves during the year, they still get the benefit of the match for the time they worked and 2) the employee benefits from the earnings on those matching contributions throughout the year. About 10% of plan sponsors providing a match contribution make the deposit once each year. IBM made the change in December 2012 and AOL in early February 2014. However, after employee and media backlash, AOL quickly reversed their decision shortly thereafter and continued to deposit the match into the plan on a per-pay basis.

Employers, as plan sponsors, have difficult decisions to make and it truly is a balancing act. These employers did not reduce the amount of the match, just the timing; not unreasonable when a match is designed to attract and retain talent. In addition, there is no requirement in ERISA for a plan to provide a match at all.

2. HAVING A HEIGHTENED SENSE OF AWARENESS REGARDING ROLLOVERS OUT OF A PLAN.

The Department of Labor ("DOL"), generally having primary responsibility for reporting, disclosure and fiduciary requirements, and other regulators as well, have their eyes on rollovers out of employer sponsored qualified employee benefit plans. Usually, employers' involvement in rollover transactions is to assure the funds are (a) rolled over to the proper institution selected by the participant, (b) timely, and (c) in the proper amount. Beyond that, they are done. What's getting attention is the rollover on behalf of a distribution-eligible participant from an employer-sponsored qualified employee benefit plan to an Individual Retirement Account ("IRA"), as opposed to a rollover to another employer's plan. The burden to make the decision as to what financial institution the rollover funds should be invested with and what investment options to select is on the participant, and it is up to them to seek the proper guidance. Often, the third-party investment institution engaged by the plan sponsor to hold and administer plan assets is familiar to the participant and funds are rolled over to an IRA sponsored by that same provider. This is one of the transactions under focus by regulators. It could be viewed that the plan sponsor's service provider improperly leveraged its relationship by recommending its own proprietary products to the distribution-eligible plan participant. On the other hand, an investment provider unrelated to the plan may have an unfair advantage simply since they are unrelated even though they may provide an essentially identical product.

There will be more surrounding this issue for sure. The focus seems to be on the investment provider receiving the rollover funds, however, as with most things, there will be an impact on the employer sponsoring the plan as it monitors its service providers and an impact on plan participants who must be aware of the regulations related to rollovers when they become distribution-eligible.

3. CONSIDERING OPTIONS TO OBTAIN RELIEF FROM DEFINED BENEFIT PLAN OBLIGATIONS.

There has been much buzz surrounding de-risking strategies, which involve reducing or eliminating a company's defined benefit pension obligations. This strategy stems from efforts to realize a reduction in future volatility of plan contribution amounts, a future reduction in plan administrative expenses and PBGC premiums, and possibly significant changes to the company's financial statements and the plan's financial reporting. Significant reductions in the liability for the defined benefit plan on the plan sponsor company's books are an attractive proposition.

Several de-risking strategies are available. One strategy is a buy-out, whereby a plan purchases an annuity contract and the risk for paying the defined benefit earned by the participant is transferred from the plan sponsor company to the insurer. Thus the insurer assumes the liability to pay the plan's benefits. In summary, those subject to the buyout, generally a specific group of retirees, are no longer plan participants as assets leave the plan to purchase the annuity contract.

There are tough decisions to make when considering such a plan of action, one being that when the risk is removed from the qualified defined benefit plan to the insurance company, participants no longer have Pension Benefit Guaranty Corporation protection for their benefits.

Plan sponsors considering a de-risking transaction will find themselves paying close attention to the annuity rates from the insurance company; they can be volatile and there is a small window to act in deciding to purchase the annuity or not.

In summary, it is not surprising that sponsors of qualified retirement plans have their hands full. The regulations surrounding qualified plans will most likely rise to address these current concerns and more. This means there is no end in sight for plan sponsors struggling to keep up, struggling with tough cost balancing decisions, trying to stay on top of decisions contemplated by regulators who have a heightened sense of participant protection and, of course, managing participants' awareness of these issues. ■

Questions? Please contact Diane Wasser at 732.243.7143 or diane.wasser@eisneramper.com.

THOUGHT LEADERSHIP

From Our Blogs

EisnerAmper professionals share comments, ideas, and insight into several professional areas through our numerous blogs. Here's just a sample of some recent posts:

"A not-for-profit organization must file the appropriate Form 990 series ("Return of Organization Exempt from Income Tax") at least once within a consecutive three-year period. Without such filing, the IRS automatically revokes the employer's tax-exempt status. Federal tax-exempt status can be reinstated if the organization applies to the IRS and is able to show there was reasonable cause for not timely filing the Form 990 series."
— from Are You Sure Your Plan Sponsor is tax Exempt? (http://www.eisneramper.com/plan-sponsor-tax-exempt-compensation-blog-0614.aspx) by Diane Wasser for our Compensation and Employee Benefits blog, posted June 4.

"One goal of ICD-10 implementation has been to improve documentation to better support the increased specificity of the ICD-10 diagnosis codes. Medical record documentation is frequently targeted by auditors because it may not support the billed procedure code. Increasing standards now will better serve providers by reducing their overall audit risk. In addition, with health care moving towards quality of services instead of quantity of services, more complete documentation will serve to increase substantiation of performance measures. "
— from Implement Operational Efficiencies During ICD-10 Delay (http://www.eisneramper.com/implement-efficiencies-icd-10-delay-health-care-blog-0614.aspx) by Nancy Clark, posted June 6 on our Health Care Services blog.

"The new Sbarro pictures itself as an artisanal fast food eatery similar to Panera Bread or Chipotle. However, no matter how Sbarro pictures itself, its departure from the Long Island business landscape is another blow to the local economy, whether it now fancies itself as a landlord or not."
— from Long Island Is Losing Another (http://www.eisneramper.com/long-island-loses-sbarro-blog-0614.aspx) by Eric Altstadter for our Eye on Long Island blog, posted June 6.

"Some are touting that this is the second coming – the second coming of the Internet tech bubble, that is. There are the hallmark signs of high company valuations, low profits and the most recent news of stock splits like the one recently announced from Apple."
— from Does the Apple Stock Split Indicate Another Tech Bubble? (http://www.eisneramper.com/apple-split-another-bubble-technology-blog-0614.aspx) by Marc Fogarty for our Technology and Life Sciences blog, posted June 4.

Or you can check us out on video! Here's EisnerAmper Partner Dan Gibson discussing tax awareness when launching a new business *(http://www.eisneramper.com/Video-tax-awareness-accounting-service-blog-0614.aspx), from our Private Business Services blog, posted June 5.*

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