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CLIENT'S tax & financial UPDATE
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A tax, business, and financial planning newsletter for our clients and friends

Eight Ways to Plan for Tax-Free Income

When you're evaluating potential sources of income, you should also be keeping an eye on their tax consequences. This is especially important if you're near a tax bracket that will adversely effect your tax picture next April. Fortunately, there are alternatives that can lower the tax bite. Here are some to consider.

Consider a real estate tax shelter. When you buy income producing real estate for investment purposes, you can take a depreciation write-off for the cost of the property and improvements against your income. Your taxable rental income will then be reduced by the amount of your depreciation deduction. This deduction is a tax-sheltered source of income, since depreciation is a non-cash expense.

Shelter business income with tax-deferred retirement plans. Up to $49,000 a year can be contributed to a participant's account in a defined contribution plan, using a formula of 25% of compensation. You can contribute the maximum to Keogh and simplified employee (SEP) plans if you are self-employed, using a formula of 20% of net business income. Strategy: If you are older than age 45, consider setting up defined benefit plans. Defined-benefit plans may permit larger contributions than defined contribution plans because you fund a specific amount and have fewer years in which to do so. In some instances, contributions can exceed $150,000 per person.

Plan for tax-free Social Security. Not all of your social security benefits may be subject to tax. To determine how much is taxable, you must look to all of your sources of income. If you and your spouse earn less than $32,000 ($25,000 for an individual), then all of your social security benefits may be exempt from tax.

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taxPOINTS

Use the $250,000 expensing election. The IRS maximum allowance of new business equipment acquired during 2010 that can be immediately deducted, rather that depreciated over a period of years is $250,000. Equipment must actually be placed in service (not merely purchased) by year-end to be deducted.

Write down inventory. If your company has inventory that has declined in value, you can deduct the decline in value. ***Required:*** Document a reduced market value for the inventory, such as by making a bona fide offer to sell some of it at a lowered price within 30 days of year-end.

Deduct bad debts: If the business uses accrual basis accounting (rather than cash basis accounting), it can deduct receivables that have become uncollectible during the year if it specifically identifies them and has evidence of their being uncollectible. Identify such debts now.

Loophole: Give your child appreciated stock instead of cash. This assumes that he will pay any capital gains tax at his lower tax rate when the shares are finally sold. A child assumes the parents' basis and holding period for the stock.

Understanding Your Office Workers

A recent national survey shows that there is a serious communication gap between business executives and office workers. The study indicates that employers who make an effort to understand the attitudes and opinions of office workers can be rewarded with greater office worker involvement in their work and, therefore, with higher productivity. Here's what the survey showed:

OPINION	PERCENT OF OFFICE WORKERS WHO AGREE	PERCENT OF EXECUTIVES WHO AGREE
"Office workers do as much as they can during their workday"	**46%**	**16%**
"A challenging job is very important to office workers"	**81%**	**51%**
"Freedom to decide how they do their own work is very important to office workers"	**71%**	**23%**
"Office workers think it is very important for executives to schedule meetings with them"	**62%**	**31%**

The Real Cost of Mortgage Points

If you've shopped for a mortgage, you've probably noticed a considerable difference among the "points" charged by different mortgage originators. On the surface, a point seems simple enough: it's 1% of the face value of the mortgage. Points are charged as an up-front fee that may or may not be deducted from the proceeds of the loan. But comparing the combination of differing rates and points can be confusing. How do you compare, for instance, a 20-year mortgage with three points against a 30-year mortgage with two points? The number you need to make the comparison is actually the "effective" rate of interest you'll pay for the face value of the mortgage plus points. For a typical 30-year mortgage, here's a comparison of effective interest rates including points.

LENDER'S RATE	EFFECTIVE RATE FOR ONE POINT	EFFECTIVE RATE FOR TWO POINTS	EFFECTIVE RATE FOR THREE POINTS
5%	5.09%	5.18%	5.26%
6%	6.09%	6.19%	6.28%
7%	7.10%	7.20%	7.30%

For other stated interest rates, ask each potential lender to calculate the effective interest—what you'll really pay including points.

Survival Marketing: When the Economy Goes Down, Make Your Sales Go Up

One of the biggest mistakes you can make is to cut back on your marketing effort when the economy show signs of weakening. Smart marketers do just the opposite because they know that their competition will cut back and will be vulnerable. In a soft economy, the best defense is a strong offense and that means an aggressive marketing program.

Six survival strategies for a weak economy

1. **Become more visible.** Cutting your advertising budget and reducing your promotional activities is like hanging out a "we give up" sign. What you really have to do is take business away from your competitors. Let the marketplace know you're out there – loud and clear. Remember that when you advertise and your competition does not, you'll be seen as the leader and customers will come to you.
2. **Beef up your guarantees.** When customers look at competing businesses, they look for quality. And the most effective way to demonstrate quality is with iron-clad guarantees. Show the marketplace that your product or service is the best by standing behind it 100%. There's no better way to attract customers than with an exciting guarantee.
3. **Get out where the action is.** Whether your sales are made in the field or on the selling floor, that's where you belong when the economy is soft. When customers are face-to-face with the president of a company, their response is always positive. In some industries, the response can be overwhelming and an increase in sales is virtually automatic. Sitting in your office is a sure way to contribute absolutely nothing to improving sales.
4. **Don't cut prices.** When everyone's worried about the economy, it's tempting to lower prices. This may give you a temporary sales boost, but it may also lead you down the road to bankruptcy. Instead of selling low prices, sell value, quality and service.
5. **Think about what your customers want.** When the economic scene is gloomy, customers' needs change. Don't forget that your customers are facing the same problems that you are facing. If you find solutions to their problems, you'll make the sales. Satisfied customers buy.
6. **Stay focused.** It's easy to spend your time looking for reasons why your business has problems. You can blame the sales force, or slow delivery from production, or a weak product line. Don't spend your energy looking for "reasons why". Instead, stay on track and concentrate on implementing an aggressive marketing program that will produce more sales.

Remember that making sales go up when the economy goes down means getting more customers. That will never happen if you cut back your marketing effort. Be bold, focused, innovative, and single-minded. You'll not only survive, you'll prosper.

Unpaid Withholding Taxes Can Mean a 100% Personal Penalty

If an employer fails to pay withholding taxes to the federal government, the IRS has the power to assess a 100% personal penalty against corporate officers, partners, or any company employee whose responsibility is to collect, report, or pay the withholding tax.

The 100% personal penalty is equal to the amount of unpaid tax and virtually no one who plays a role in running the company can escape the consequences of failing to pay withholding taxes. The penalty can be imposed against the individuals who run the business or sign company checks. It has even been levied against individuals who had the authority to decide which creditors should be paid, against individuals who were directors of the corporation but not employees, and against individuals who resigned from the company before the withholding tax was due.

The 100% penalty is imposed in cases of "willfulness", which means a "willful" failure to withhold or pay the tax. It does not require "evil intent" and is simply the intentional disregard or indifference to employer withholding tax requirements.

Although the penalty is not assessed if the employer pays the tax, it gives the IRS a very effective means to collect unpaid withholding taxes.

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Open an IRA and contribute to it each year. Even if you can't deduct an IRA contribution, income from individual retirement accounts is tax-deferred. You pay income tax only when you withdraw your funds, usually when you're retired and in a lower tax bracket. Meanwhile, the interest from your IRA investments keeps compounding.

Contributions to a Roth IRA are not deductible. However, all Roth IRA withdrawals may be tax free. Provided you are at least 59 1/2 years old, you can take tax-free withdrawals from a Roth IRA after five years.

Use the interest from life insurance. When you cash in a life insurance policy, you'll be taxed on the interest that's been accumulated. But there is a way to use certain policies to avoid taxes and enhance your cash flow. Some life insurance policies actually allow you to "borrow" against the annual interest they generate. For example, $20,000 invested in a life insurance policy that pays 7% a year will generate $1,400 in interest which is available for you to "borrow". You will have to pay a modest amount of interest to the insurance company for the "loan", but the loan proceeds won't be taxable.

Look at annuities. Another insurance-based option is the tax deferred annuity. Sometimes called single-premium deferred annuities, these are investments you can make with an insurance company at a specified rate of interest. Unlike life insurance policies, however, you can't borrow against this income until you cash in the investment. But it's only when you cash in the annuity that you pay tax on the income.

Consider municipal bonds. There's no federal income tax on interest earned from municipal bonds, which are usually sold at $5,000 minimum with maturities anywhere between 30 days and 30 years. If you're investing a smaller sum, or prefer that experts manage this part of your portfolio, you can invest in municipals, through specialized mutual funds. If you're looking for rapid turnover without the risk of long-term changes in the value of your investment, there are mutual funds which invest only in very short-term municipals that mature in 60 days. You can usually buy into these funds at a lower minimum – between $1,000 and $5,000 – and can often write checks against your account.

Whichever way you invest in municipals, however, you do need to keep an eye on the state tax. Interest from municipals is exempt from state tax, but only when the bonds are issued in the state where you live. If you're in Massachusetts, for example, and invest in DesMoines municipals, you won't pay federal income tax on the interest, but you will be liable for Massachusetts state income tax.

Buy U.S. Treasury Bonds. When you buy U.S. Treasury bonds, your tax situation is exactly the opposite of the situation with municipal bonds. Regardless of where you live, you'll have to pay federal tax on the interest from Treasury bonds, but all U.S. Government securities are exempt from state tax.

Strong Solutions for Credit Problems

Even the best of customers sometimes fall past-due. You should have an established credit policy so you can handle these problems when they occur. Here are some typical solutions.

1. Ship C.O.D. only.
2. Get a personal guarantee of payment from a company officer.
3. Shut off a customers' credit until all back bills are paid in full.

It's just as important to watch for signs that customers' credit might be weakening. Here are some typical signs:

- Sudden increase in purchases
- Frequent changes to new banks
- Weak excuses for payment slowdown
- Reluctance to reveal financial information
- Annoyance at attempts to collect
- Factoring of accounts receivable
- Lowered credit agency rating
- Erratic pattern of payments
- Unresponsiveness to collection attempts