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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

Tax Opportunities for a Comfortable Retirement

There are several ways to take advantage of loopholes in the tax laws to enhance your retirement. Here are the most effective strategies to consider.

Sell your home tax-free.

The tax law does much more for home owners than simply letting them take a $250,000/$500,000 tax-free gain on sale. Here are additional ways the law helps some owners save taxes:

- A home qualifies as a principal residence, on which you can take tax-free gain, if you've lived in and owned it for only two out of the previous five years. So, if you moved out of your home up to three years previously, and perhaps have rented it out for profit in the meantime, it will still qualify as a residence on which you can take tax-free gain.
- You can take tax-free gain multiple times. The law allows you to use the $250,000/$500,000 exclusion once every two years.
- Transfers of homes to children made easier. Some parents who approach retirement age desire to make a gift of the family residence to their grown children. The drawback to this was that when a home had appreciated in value, for income tax purposes it was better for children to receive it by inheritance than by gift. Current tax law eliminates this problem for many by enabling a child who receives a home by gift to use the $250,000/$500,000 exclusion to eliminate the gains tax that otherwise would be due, provided the child uses the home as his/her principal residence for at least two years.

CONTINUED ON PAGE **4**

taxPOINTS

Loophole: Reconstruct missing W-2's. If a company you worked for went out of business, or your employer hasn't yet given you a Form W-2, you can reconstruct your salary and withholdings records on Form 4852, ***Substitute for Form W-2, Wage and Tax Statement.*** On that form, prepare your best estimate of your salary and withholding, explaining how you arrived at the figures, and send it in with your tax return.

Money saver. Reconstruct debt. Low interest rates are an incentive to refinance old debt as well as providing tax benefits. Interest on consumer debt cannot be deducted, but mortgage interest (within limits), business interest, and investment interest up to investment income is deductible. ***Strategy:*** Refinance high interest non-deductible consumer debt with low interest fully deductible debt.

Tax-free income from your home or vacation home. If you rent out your home and/or a second home that you own (such as a vacation home) to others for fewer than 15 days during the year, the rental income you receive is totally tax free – you don't even have to report it on your tax return. This is one of the simplest and best tax breaks in the tax code.

Bad debt writeoffs. Loans made to friends that are not repaid can be deducted as non-business bad debts on Schedule D of your individual income tax return. To be deductible, make sure you have a promissory note and have made a legal attempt to collect the money.

Better Marketing

Disciplined direct marketing.

Many businesses are finding that direct marketing offers a productive alternative to other channels of distribution. Many of the guidelines for direct marketing are the same as those for any other successful sales effort, but there's one cardinal rule the direct marketer shouldn't ignore: *Develop one winning product at a time and focus on it.* The best direct marketing doesn't confuse the prospect with various alternatives. It spotlights one product and concentrates on its benefit to the customer.

Don't restrict your direct marketing efforts to gaining new customers. In fact, the customers who have already bought your product are your best bet for direct marketing.

You can go back to them again and again. And when you choose the focus for your initial direct marketing effort, you should be thinking about a followup – additional products that will appeal to those who have already responded to your first offer.

In short, it's OK to promote a group of related products, but sell them one at a time.

Conduct your own focus group.

Market researchers know that one of the best ways to get actionable marketing information is through a focus group – a forum in which a professional researcher poses questions to a group of potential buyers, distributors, or consumers.

The questions asked in a focus group are usually different from those asked in a survey, where "yes/no" or multiple-choice answers are the norm. In focus groups the questions are open-ended. The person conducting the research doesn't look for specific responses, but asks for general opinions.

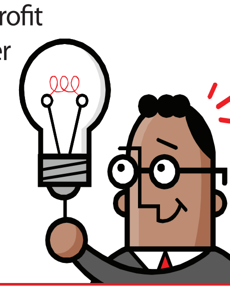
You don't need a costly formal focus group facility to do this kind of research. There is no reason, for instance, why you can't gather a group of your customers over lunch or late afternoon wine and cheese. In this informal setting you can invite, for example, suggestions about improvements or get reactions to ideas for new products. Your customers will probably be flattered that you've asked their opinion and you'll get a perspective on your business that may surprise you.

Smarter Selling

Listen before you leap: Control your enthusiasm for what you're selling until your prospective customer has described his problems to you. If your initial presentation is too forceful, the customer can interpret it as "hard sell" with no consideration for the customer's needs.

A better approach is to listen carefully for what the customer really needs and then use your enthusiasm to show how your product or service can satisfy those needs. Your message will then come across as a desire to help the customer and you'll be seen as someone the customer wants to work with.

Strongest sales approach: Always present your product, your service and your company as a contributor to the customer's bottom line. Your objective should be to position yourself as the customer's partner, not just another vendor of goods or services. You'll sell much more effectively if you are perceived as a profit booster rather than a cost contributor.



How to Cut Capital Gains Taxes on Investments

Capital gains tax rates are low and you can still take steps to reduce your capital gains taxes even more. If you have investments in securities, here are some valuable tips.

Sell the correct stock. For example, let's assume that you made three separate purchases of the same stock - 100 shares at $10 a share, 100 shares at $20 a share, and another 100 shares at $30 a share. Assume that you can sell the stock now at $40 a share. If you sell 100 shares now and don't tell your broker which of the three purchases to sell, the IRS will consider that you sold the first $10-per-share purchase you made, and you'll be taxed on a $30 gain.

You can avoid this problem by telling your broker to sell the 100 shares of stock you bought at $30 so your taxable gain will be $10 a share. (You might, however, want to sell the $10 stock if you have enough capital losses to offset your gain.)

Offset gains with losses. Consider selling some stocks at a loss if you have large capital gains. Remember that although you can deduct only up to $3,000 in capital losses from ordinary income, there is no limit on the capital losses you can use to offset capital gains.

If you're reluctant to take a loss on a stock you think will go up, you can sell it and buy it back as long as you wait at least 31 days before you buy it back. If you don't wait at least 31 days, the IRS will deem the transaction a "wash" and won't allow you to take a loss.

Sell in the right year. Consider selling now if you expect to be in a higher tax bracket next year. If you think you'll be in the same tax bracket, you may be better off selling in a later year and deferring the tax on your gain.

Make a charitable contribution of appreciated securities. If you've owned a stock for more than a year and donate it to charity, you can deduct its full market value as a charitable contribution. Be careful, however, because the gain on property given to a charity is subject to the Alternative Minimum Tax.

Tax Tips

When are you safe from a tax audit?

The IRS has three years from the date you file your return or from the filing deadline (whichever is later) to audit your return. Exceptions: if you underreport your income by more than 25%, the IRS has up to six years to impose a penalty; and if you fail to file or if you file a fraudulent return, there is no time limit for the IRS to take action.

Getting the Most out of Zero-Coupon Bonds

Zero-coupon bonds ("zeros") can be an excellent investment but despite their widespread availability, many investors still don't understand them.

How zeros work. A zero-coupon bond is sold at a fraction of its face value. The bond pays no cash interest during its term. The undistributed interest from a zero is automatically reinvested every year at the same guaranteed rate. When a zero matures, all interest earned plus the principal is paid in a lump sum.

Benefits. The positive aspect of zeros is the effect of compound interest. For example, if you paid $10,000 for a 5% ten-year zero, it would be worth about $17,000 at maturity. But if you invested $10,000 in a conventional bond that paid 5% a year, the interest you'd receive over ten years would total $5,000.

Drawbacks. Even though you receive no annual interest from a zero, you must pay taxes on the bond's imputed interest each year. You can, however, avoid this tax by buying zeros through a tax-exempt IRA or Keogh account. Another caution: the market value of a zero-coupon bond can fluctuate during the period before it matures. If interest rates go up, the market value of a zero will go down. Furthermore, many zero-coupon bonds are not as liquid as other investments so it's best to hold a zero until it matures.

Zero-coupon bonds are issued by corporations, banks, and by federal and local governments. There are also mutual funds which invest only in zeros. The best strategy for buying zero-coupon bonds is to buy them through a tax-exempt retirement plan and to hold them until maturity.

CONTINUED FROM PAGE 1

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Sell your home to your children and rent it back from them.
Here's a way that both you and your children can get benefits from Uncle Sam. You benefit because you get retirement money from the sale of your home. You can also pay less rent because your children can charge you a "fair rent", which one Tax Court has ruled can be lower than "fair market rent" since renting to relatives entails less risk than renting to strangers.

Your children benefit because they can deduct mortgage interest, taxes, and depreciation....deductions that mean greater tax savings to your high-tax-bracket children than they mean to you as a lower-tax-bracket retiree.

Control your retirement plan distribution.
The law requires that you begin to withdraw money from your IRA by April 1 following the year in which you become 70½. By using actuarial tables, you may be able to take out less money during the early years to avoid increasing your income to a higher tax bracket. Your IRA trustee can tell you whether you can slow down your retirement plan distribution withdrawals.

Municipal bond interest.
This is generally tax exempt from federal income tax – and may be exempt from state and local income tax as well. Caution: Certain municipal bonds, known as "private activity bonds" (because they finance nongovernmental functions, such as construction of sports stadiums), pay interest that is taxable under the alternative minimum tax (AMT).

Use life insurance to pay your estate taxes.
Look into establishing a trust to purchase life insurance, the proceeds from which would pay your estate taxes. If you're in your early sixties or younger, life insurance premiums may be a low-cost way to pay estate taxes.

Protect your assets against nursing home costs.
The government won't pay your nursing home costs until all money in your name has been exhausted. But if your money is in a trust that pays income and doesn't give you access to the principal, only the interest will go to the nursing home and the principal will remain intact. Be sure to consult an attorney about the laws in your state, because many states will not honor such a trust if it is set up within two years of the time you enter a nursing home.

A wise way to use a power of attorney.
Protect yourself against the possibility that you might become incapacitated and be unable to manage your money. By giving power of attorney over a special bank account to someone you trust, you can be sure that money will be available to take care of you.

Choosing the Best Sales Compensation Plan

There are three basic ways to compensate sales personnel. Picking the one that's best for your company can make a real difference in sales productivity.

1. Straight salary is often used for lower echelon sales personnel. Its major drawback is that it offers no incentive to perform beyond a routine level. Straight salary can be useful, however, when employees are involved in both sales and other jobs because it establishes parity within the workforce.
2. Straight commission is most effective when a salesperson is independent (such as a manufacturer's representative) or when a salesperson is essential to closing a sale. It works best when there's enough demand in the marketplace to assure sales.
3. Salary plus commission provides incentive to sales personnel, but to use it effectively, companies must find the right balance between salary and commission.