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A tax, business, and financial planning newsletter for our clients and friends

Celebrate the New Year by Cutting Your Taxes

Many people don't realize that sound tax strategies are part of a solid personal financial plan. So what's practical and effective for some taxpayers may not be the best strategy for others. However, regardless of your financial goals, it's important to look at possible tax strategies now, so you can generate tax savings for the entire year. Here are some of the best ways you can save tax dollars this year.

1. First, look at the big picture. Establish your investment goals and your insurance, education, and retirement needs. Make sure you understand the benefits that your company can offer you. Tax savings strategies will only make sense to you when you have a financial plan.

2. Make your retirement plan contribution now. Even if you can't take a deduction for your contribution, remember that the money you put into the plan will compound on a tax deferred basis. Don't wait until the end of the year because you'll loose the benefit of compounding. Be careful however, that you won't need the money until you are age 59½. Earlier withdrawals may incur an IRS penalty.

3. Make the maximum allowable salary contribution to your company's 401 (k) plan. If your company makes matching contributions, the return on your investment is immediate. Furthermore, the tax on your 401 (k) plan is deferred. *Extra benefit:* Many 401(k) plans offer borrowing privileges to participants.

4. Don't be trapped by the Alternative Minimum Tax. If you have large itemized deductions or donate large

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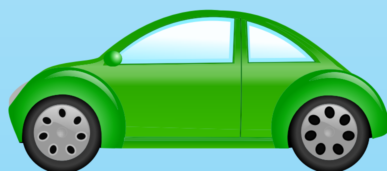
taxPOINTS

Worker classification. The IRS is always on the lookout for misclassification of workers as independent contractors rather than employees. If the workers are independent contractors, the company avoids paying employment taxes. But you must treat workers as employees rather than independent contractors if you exercise control over how, when, and where they perform their duties. **Important:** Treat all workers doing the same job in the same manner, as either employees or independent contractors. If you treat some as employees and others as independent contractors, the IRS can say they're all employees and assess employment taxes.

Deductible driving costs. You can deduct actual mileage costs when you use your car for business purposes. As a general rule, you must keep a diary that includes the beginning and ending odometer readings for each trip, as well as the trip's purpose. **Loophole:** The diary entry is sufficient to prove your deduction if you are taking the IRS standard mileage rate for driving costs. You don't need to collect receipts for gasoline, repairs, insurance and other automobile expenses unless you're deducting your actual driving expenses rather than the IRS rate.



How to Cut Overhead Without Hurting Morale

When payroll cuts become necessary, many companies face a drop in employee morale that can seriously damage operations. Key employees frequently become less productive and are more receptive to other job opportunities.

Here are some proven strategies that can help you make overhead cuts without damaging employee moral.

- Tell your employees how the cuts will actually strengthen the business. For example, explain that the money saved will be invested in new equipment and more advertising to make the company stronger. Never announce that people must be terminated because expenses are too high.
- Make your cutbacks equitable. Don't create unnecessary resentment by keeping excessive top management perks.
- Use incentives to encourage voluntary resignations. Consider options such as early retirement packages. Or help employees set up their own businesses with you as their first customer. Custodial workers, graphic designers, and others can often provide their services as subcontractors on an as-needed basis.

Sales Management Mistakes to Avoid

- **Don't set impossible quotas.** Many managers automatically increase individual sales quotas every year so that salespeople have to book more business before they can earn incentive income. This is a common approach to keeping costs down, but it can have an adverse effect on sales because salespeople become discouraged by quotas which are impossible to reach and may leave the company for greener pastures. If selling costs are a real problem, it's usually a better strategy to keep sales quotas realistic and offer lower commissions instead.
- **Don't limit income potential.** Putting a ceiling on total sales commissions and bonuses tells salespeople that once they've reached the limit, there's no reason for them to continue to work for additional sales.
- **Don't waste sales ability.** Good salespeople need new challenges. Selling the same customers over an extended period may make it easier to reach their quotas, but they soon realize that increasing their sales (and their income) is becoming more and more difficult. It's much better to reassign territories to provide new opportunities for salespeople to improve their income.

How to Save Tax Dollars by Increasing the Basis of Assets Acquired

Many taxpayers think they can save taxes by giving property to a close relative before they die. If you're thinking about doing this, you could be making a mistake that can cost your heirs a substantial amount of tax money.

Take Ben Williams, for example. For many years, Ben had been the favored painting contractor in his home town. Inside or outside, from doorsteps to double-deckers, Ben Williams got the call when homeowners wanted a first class paint job at a reasonable price.

Ben wielded a mighty paint brush, but his climb up the ladder of success was modest. As he gave a fresh new look to house after house, Ben wondered when he could touch up his financial affairs and buy a house he could call his own. The opportunity finally came in 1990 when Ben, negotiating from atop his painter's scaffolding, paid $150,000 for a comfortable cottage he was painting. It was a proud moment for Ben and it proved to be a sound investment.

Now, if there's one thing that house painters have, it's plenty of time to think. And as Ben approached retirement, his thoughts turned to how he could save his family from an excessive tax burden and costly legal fees when he finally departed to meet The Great Painter In The Sky.

By the time he retired, Ben's strategy was clear to him. His estate was modest – a little cash, some personal effects, and the house he had bought which had appreciated considerably in value. So Ben made a gift of his residence to his only son, George, and spent his remaining days thinking he had painted a better tax picture for his family.

Ben Williams remained in the house until his death in 2012. Within a few months, George sold the property for $370,000 – its fair market value – for a gain of $220,000. But when George Williams filed his 2012 individual income tax return, he discovered that for tax purposes, the cost basis of property acquired by gift is that of the last preceding owner who did not acquire the property as a gift. Since the last preceding owner was George's father, who had paid for the house with his own hard earned money, the cost basis for the property will be what Ben Williams paid for it - $150,000. Consequently, when George files his 2012 individual income tax return he will need to include the $220,000 gain from the sale of the house and pay a substantial tax on the gain – a hefty tax burden that Ben Williams thought he had avoided.

A BETTER SOLUTION

The income tax cost basis for property acquired from a decedent is generally the fair market value of the property on the date of the decedent's death. This is called, "the stepped-up basis rule" and, if Ben Williams knew about it, he could have protected his family from paying any taxes on the gain from the sale of the property.

Under the stepped-up basis rule, the basis for property acquired by inheritance is increased from actual cost to the fair market value of the property at the time of the owners' death. This shields beneficiaries from paying income taxes on the appreciation of the property prior to the death of the owner.

Therefore, if Ben Williams had retained ownership of his house, its estate value would have been its fair market value when Ben died. George's stepped-up basis for tax purposes would then have been $370,000. Because George sold the property for its fair market value, he would have had to report no taxable gain on his 2012 federal income tax return and his income taxes on the appreciation would have been reduced to zero. That's a huge savings, which is enough to paint quite a few houses.

Ben Williams was a professional painter, but he should have brushed up on his knowledge of the tax law by consulting with a professional accountant before he gave his house to his son. Just as in painting, a little preparation can go a long way toward getting the best possible result.

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Celebrate the New Year by Cutting Your Taxes (continued)

charitable gifts of appreciated property, you may be subject to the alternative minimum tax. If you are an AMT target, your tax plans may need to be drastically changed. Make sure to protect against the AMT at the beginning of the year, not the end when it may be too late to change strategies.

5. Use your W-2 withholding wisely. Consider changing the amount withheld from your paycheck. Deliberately overpaying the IRS doesn't make sense. If your financial situation changes during the year, you can always adjust your W-2 withholding upward. Your goal should be to pay no more and no less than your actual taxes for the year.

6. Use debt to save taxes. Although personal interest is no longer deductible, home mortgage interest, investment interest and business interest are still deductible with certain limitations. Now is the time to retire your personal debt and take advantage of fully deductible interest.

7. Shift income to save taxes. Use gifts as a tax sheltered way to shift income to children who are in a lower tax bracket. The maximum amount that a parent can give tax-free to each child is $14,000 a year. If a husband and wife make a joint gift, the maximum amount is $28,000.

If your child is no longer your dependent and not subject to the kiddie tax, the earnings on your gift to the child are taxed at the child's tax bracket, which may be lower than yours.

If you are supporting your elderly parents, you can use the same strategy for making an annual gift to them. If your parents are in a lower tax bracket than you, you'll save taxes by transferring income-producing assets to them. The sooner you make the gift, the more taxes you'll save. The same limits apply to gifts to parents as to gifts to children.

8. Use Treasury bills to defer tax on interest income. Buy one year or less Treasury bills that come due in January of 2014. Since the T-bill interest isn't taxable until the T-bill comes due, you can shift almost a full year of interest income into 2014.

9. Invite business contacts to your house. You can deduct 50 percent of the cost of business meals, even if the meals are served in your own house. Of course, the meal must be a business meal, and you must keep a record of who was there and what business discussions took place.

10. Review your 2012 tax return to find items that can be carried over to 2013. For example, you have capital loss carryovers from 2012, you can offset your 2013 capital gains by a like amount. Additional carryovers include net operating losses, charitable deductions, investment interest expense, and various tax credits.

Gambling is a Risky Business at the IRS

If an occasional trip to the race track is one of your hobbies, you probably know that your winnings are taxable and your losses are deductible only to the extent of your gambling gains. The IRS certainly won't object to your paying taxes on your race track winnings, but proving your losses is a horse of a different color.

When one horseplayer brought a bag of parimutual tickets to tax court as proof of his losses and asked that their cost be deducted from his winnings, the court declared him a loser because the tickets had footprints on them.

Another veteran horseplayer produced a similar collection of losing tickets as proof of his losses. But the court noticed that although the tickets had no heel marks, their denominations and serial numbers were so varied that the gambler would have had to buy many tickets for the same race at a dozen different parimutual windows. Needless to say, this gambler lost his tax bet too.

Proving a gambling loss for tax purposes requires very convincing evidence. Your best bet might be to take up golf.

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