Harris, Burnett & Schmiesing CPAs

7730 Olentangy River Road
Columbus, OH 43235
(614) 436-CPAS

CLIENT'S tax & financial UPDATE

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

How To Cut Overhead Costs for A Better Bottom Line (part 1)

Inflated overhead costs are a progressive disease in many businesses. Increases in one small overhead item at a time can add up until they finally gobble up a sizeable portion of profits and create serious cash flow problems.

Preventative medicine is the best way to avoid these problems. A good record keeping system will let you examine overhead costs every month to make sure they remain relatively constant. Payroll and expense accounts, telephone costs, and equipment and supply costs should receive special attention.

But the real key to keeping overhead down is to see that each area that generates overhead costs is under the direction of one individual. When expenses appear to be getting out of hand, you can then meet with the person in charge of a problem area to discuss why costs are climbing and how changes can be made to bring them under control.

PURCHASING PRACTICES

The cornerstone of improved net income is to minimize the cost of goods sold to increase gross margin. To achieve this goal, the total purchasing function must be assigned to one person. When several people are involved in buying, there is no ultimate responsibility and wasteful and sloppy

purchasing practices develop quickly. In addition, it becomes easy to lose track of what has been bought and what has been ordered. Chances are also good that purchases will be made from friends rather than from suppliers who offer the most favorable prices, the best quality, and the most reasonable terms.

When the purchasing function is centralized, the responsible individual

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taxPOINTS

LEGAL FEES

Marital actions. As a general rule, attorney's fees in marital and custody actions are not deductible. This is so even if marital assets include a business or investment property. If legal fees are for tax advice, they are deductible. Also, legal fees paid to protect a certain asset may be added to basis. It is important for the attorney to separately bill for such services. Child support and property settlements incident to a divorce are non-taxable, so related attorney's fees are nondeductible. **Loophole:** In the case of a spouse who pays attorney's fees to secure alimony, the fees are deductible, since the alimony is taxable.

Social security claims. Attorney's fees to establish a claim to Social Security benefits, (e.g., to qualify for disability payments) are deductible to the extent that the benefits are taxable. Depending on income, up to 85% of benefits may be taxable – so that portion of the fees may be deductible as a miscellaneous itemized deduction.

Criminal actions. Generally, attorney's fees to defend oneself in a criminal matter are not deductible. For example, fees to mount a Racketeer Influenced and Corrupt Organizations (RICO) Act defense are not deductible even if an adverse determination results in forfeiture of property under the law. However, if the case arises in a business context, the fees may be deductible.

The Ten Most Common Failures in Personal Financial Planning

There's a general consensus among financial planners that most people make the same mistakes in planning their personal finances.

1. Failure to have a family budget. A few minutes with a pencil and paper can go a long way toward helping you keep your spending under control.

2. Failure to involve other family members. It's understandable when one spouse makes most of the financial decisions, but it's much easier to meet financial goals if both husband and wife are involved in the planning process. For example, both spouses should meet with the family accountant and lawyer.

3. Failure to insure personal property at replacement value. For a modest sum, you can buy replacement cost insurance for almost all personal property. Discuss possible exceptions with your insurance agent.

4. Failure to use employee benefits properly. The two most common examples are inadequate disability insurance (which is relatively inexpensive to augment) and poor utilization of payroll contributions to savings and retirement plans.

5. Failure to diversify investments. Mutual funds such as index funds which are not investment specific offer the best opportunity for diversification.

6. Failure to use the proper attorney. For preparing wills and trusts, consult an estate-planning specialist instead of a general-practice attorney.

7. Failure to have excess liability insurance. One of the best investments you can make is the very small premium for $1 million in excess liability insurance.

8. Failure to have enough cash for emergencies. The rule-of-thumb to protect yourself against emergencies is to put aside six months for living expenses.

9. Failure to project taxes. Without proper tax projections, seemingly good investments can create an unexpected cash shortfall.

10. Failure to establish financial goals. Put down on paper exactly what your goals are and what their cost is. Then weed out those which are impractical or unattainable.

Tax Planning

Do It Now

Adjust your 2012 withholding tax payments so that, by the end of the year, they will equal your expected 2012 income tax. This is the safest and best way to make sure that you'll pay the required amount of taxes during 2012 to avoid IRS underpayment penalties.

Lower Your Salary And Make More Money

If your incorporated business pays you rent for real estate that you own personally, the tax laws can have a significant impact on your personal income tax planning.

Tom Hunter is a good example. Tom owns Hunter Luxury Cars, Inc., a very successful automobile dealership that Tom built from the ground up. Luxury cars had been a way of life for Tom since the day his father showed up in a gleaming new '68 Cadillac. Tom cared for that car as if it were a member of the family and the high point of each Saturday was the half-hour neighborhood drive that was Tom's reward for washing and buffing that treasured automobile.

Years later, Tom founded Hunter Luxury Cars. Thanks to Tom's driving ambition, the business got off to a fast start. One after another, Tom delivered Mercedes, Jaguars, and BMWs to satisfied customers. As he steered the business toward even greater success, Tom bought some land, built a new showroom, and rented the property to his now incorporated business.

Like many taxpayers in his situation, Tom reasoned that if the business paid him a low enough rent, he could report a loss on his rental property, deduct the loss on his personal income tax return, and lower his income taxes accordingly.

By 2011, Hunter Luxury Cars, Inc. was humming along like a well-tuned engine and was paying Tom a salary of $170,000 a year. Because of the low rent he receives from the corporation, Tom will show a $40,000 loss on his property and he planned to write it off on his 2011 personal income tax return.

But Tom's tax plan suddenly ran out of gas when he filed his federal income tax return. Based on his $170,000 salary, the $40,000 net loss on his rental property, 2011 joint return rates, personal exemptions of $7,400, and ignoring all other deductions, Tom's federal income taxes totaled $30,350, far more than he had expected.

A BETTER SOLUTION

Tom's tax plans came to a screeching halt when he discovered that he could not deduct his $40,000 rental loss. Under the tax laws, rental losses from property in which the taxpayer is an active management participant are considered passive losses. Passive losses can be deducted only to the extent that they offset passive income. In addition, passive losses cannot be deducted from active income, such as wages.

However, a special exception applies to passive losses from rental property. This exception permits a deduction of up to $25,000 in rental losses in excess of passive income for taxpayers whose adjusted gross income is $100,000 or less. The $25,000 is phased out for taxpayers whose adjusted gross income exceeds $100,000. If, as in Tom Hunter's case, a taxpayer's adjusted gross income is more than $150,000, no deduction is allowed.

Although passive losses which are not deductible in a current year may be carried forward to future years, the tax bite that Tom Hunter faces for 2011 could have been greatly reduced.

If Hunter Luxury Cars, Inc. had paid Tom a salary of $130,000 instead of $170,000, he could have received the $40,000 difference in the form of additional rent. His total income will still be $170,000, but his federal income taxes will then be $20,000 instead of $30,350.

It doesn't pay to spin your wheels in the tax law quagmire. See your accountant for a professional tax planning tune up.

Tax Tip

Summer day camp can provide a tax credit.

If your child attended day camp this past summer, the expense paid may qualify for a tax credit. The credit may be as high as 35% of qualifying expenses. The maximum amount of expenses that can qualify for the credit is $3,000 for one child ($6,000 for two or more children). The general rule for eligibility is that both parents must work or be full-time students and show that it is necessary to provide child care for a child under age 13 at the time the expenses are incurred. The credit rate is phased down according to the taxpayer's adjusted gross income.

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How To Cut Overhead Costs For A Better Bottom Line

gains leverage with suppliers and is able to apply experience and expertise to every purchasing decision. In addition to immediate cost benefits, centralized control over inventory levels and reorder points greatly facilitates future planning.

RECEIVING PRACTICES

Profits can evaporate very quickly unless one person is responsible for receiving all purchased goods. The receiving function not only involves seeing that goods are received in the proper quantity and condition, but that they are subsequently stored in the proper place as well.

Purchased goods that are left lying around are subject to damage. Even worse, the risk of their being stolen or pilfered is greatly increased. And improperly stored goods can result in costly duplicate purchases and wasted time by employees looking for merchandise.

PLANNING AND SCHEDULING PRACTICES

Thoughtful planning is the key to receiving inventory on time and to supplying goods and services according to schedule. Every step of your business - from purchasing through sales and collections - must be worked into the plan. Ultimately, the "where, when, and what" of each element in the plan will indicate the best possible use of manpower, equipment, inventory, and cash. Good planning makes a substantial contribution to reducing overhead.

QUALITY CONTROL

In a manufacturing firm, quality control is an integral part of the production process. In other types of businesses, quality control means scrupulous attention to detail in every area of business operations.

Defective or damaged products are a major cause of increased overhead costs. Additional expenses for employees time and materials add up very quickly. And the expense of poor customer relations contributes significantly to ultimate costs.

When damaged or spoiled goods are detected, they should be isolated immediately and sold at reduced prices if necessary, but never mixed with regular inventory. Efficient quality control not only lowers overhead costs, but it improves customer relations as well.

Part Two of this article will appear in the next issue of Client's Tax and Financial Update.

How To Compare After-Tax Bond Yields

When you are deciding whether to buy tax-exempt municipal bonds or taxable corporate bonds, your tax bracket will tell you whether the lower interest on tax-free bonds makes them a better investment. Here's a simple way to help you make the right decision.

1. Divide the tax-free yield by the taxable yield.

2. Subtract the result from 100%. This will give you the tax bracket at which each of the investments will result in the same yield.

3. If you are in a higher tax bracket than the bracket you calculated in step two, the tax-free bond will give you a higher after-tax yield. If you are in a lower tax-bracket, the taxable bond will give you a better after-tax yield.

For example, assume that you are considering a tax-free bond that yields 6% and a taxable bond that yields 8%.

1. 6% divided by 8% equals 75%.

2. 100% less 75% equals 25%.

3. If your tax bracket is higher than 25%, the tax-free bond will give you a greater return. If your tax bracket is less than 25%, the taxable bond will give you a better return.