CLIENT'S tax & financial UPDATE

VOLUME 35 / NUMBER 4

MARCH - APRIL 2013 ISSUE

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

A Better Way to Handle Merit Pay Increases

Business Bad Debts

Nonbusiness Bad Debts

Consider Taxes When You Buy A Business

401(k) Plans

Tax Benefit of Single Premium Life Insurance

Getting the Most Out of Zero-Coupon Bonds

Savings Bonds: A Tax Shelter for You and Your Children

Marketing Tips: What Makes a Quality Sales Force

Manufacturer's Deductions

A Better Way to Handle Merit Pay Increases

Although merit pay increases are important to a healthy business, they present pitfalls which some employers don't recognize. One drawback to merit increases is that they increase an employee's salary for as long as the worker remains with the company; once you've given a merit raise, it's very difficult to take it away. Furthermore, merit raises also increase certain benefit costs which are usually tied to salaries.

Merit increases can create other problems, too. They can often be risky because it's difficult to raise prices to offset higher payroll costs. And if merit raises aren't given consistently to all deserving personnel, they can actually lower employee morale.

How to make merit raises work

The first rule is to give merit raises only to employees whose performance is obviously outstanding. Other workers should be rewarded with bonuses, which are not a recurring expense and don't affect the cost of benefits.

To limit merit raises only to truly deserving employees, you must identify the jobs which are really vital to the company. You must then quantify the critical aspects of those jobs so you can give merit increases to the workers who excel in those aspects and who, in your judgement, are dedicated to the well being of the company.

The first step is to break each job down to specific tasks. Next, measurable standards of performance must be set for each task. Once this has been done, an importance rating must be

assigned to each task. This is necessary because an employee might be doing everything extremely well except for the most important aspect of the job.

CONTINUED ON PAGE 4

taxPOINTS

Business bad debts are deducted against business income as ordinary losses. There is no annual limit on the amount of these losses. They can be claimed for wholly or partially worthless debts.

Nonbusiness bad debts are treated as short-term capital losses. Sole proprietors and owners of pass-through entities can deduct them only to the extent of their capital gains and up to an additional $3,000 of salary and other personal income each year. Only worthless nonbusiness bad debts are deductible at all.

Loophole: Consider taxes when you buy a business. What you buy may not be deductible, or may be deductible only over a long period. As a buyer, you want to structure an acquisition so that you gain as many tax write-offs as quickly as possible. You might even be willing to pay more for something to get a more favorable tax treatment.

- Goodwill, covenants not to compete, trade names and trademarks, copyrights, and contract acquisitions are amortized over 15 years.
- Equipment and software can be depreciated and amortized over three to seven years.

Tax Loopholes

Loophole: 401(k) plans

You're really missing the boat if you're not contributing the maximum allowable amount to your company's 401(k) retirement plan. Although the tax code places certain restrictions on IRA contributions, the 401(k) plan remains as one of the best available tax loopholes.

The law permits a maximum 401(k) contribution of $17,500. Individuals age 50 or over may make an additional "catch-up" contribution of $5,500, if the plan permits this type of contribution. Income taxes on both the amount of the contribution and on the earnings inside the 401(k) plan are deferred until you withdraw the money.

Extra bonus: The amount of the federal, state, and local taxes that is withheld from your paycheck is based on your salary minus your 401(k) contribution. **For example,** if your salary is $70,000 a year and you contribute the maximum $17,500 to the plan, your federal, state, and local taxes are calculated as if your salary is only $52,500.

Since less taxes are withheld from your paycheck, part of your 401(k) contribution actually pays for itself.

Tax Benefit of Single Premium Life Insurance

Single premium life insurance is one option of life insurance policy. This type of life insurance policy has a set purpose for individuals who choose it and may benefit one group of people over another.

What is Single Premium Life Insurance?

A single premium life insurance policy is one which the insured pays a single premium at the initial enactment of the life insurance policy and the payout upon their death will be income tax-free for the beneficiaries. For those who have the money to pay up front for a single premium life insurance policy this is an optimal policy to consider.

Benefits of a Single Premium Life Insurance Policy

One of the big benefits to the single premium life insurance policy is that the payout upon the death of the insured is income tax-free. This is a good option for those insured individuals who don't want to leave their beneficiaries with taxes to pay and wish to provide them with the entire coverage amount.

Another benefit of the single premium life insurance is that the insured does not have to worry about paying an annual premium. Once the single premium is paid they are paid up on the policy. Again, although this may only be an option for those who have a good amount of money to spend up front, it is one which will come in handy to the insured who chooses the single premium life insurance policy.

Also, this type of insurance policy can be seen as an investment. Since the amount can increase throughout the years resulting in a larger payout than the initial single premium payment, the investment portion of the single premium life insurance is highly desirable for many.

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 $16,300 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.

Savings Bonds: A Tax Shelter for You and Your Children

U.S. savings bonds are an attractive investment. They are 100% safe and sometimes pay a higher rate than longer term Treasury bonds. In addition, the tax on the interest they earn can be deferred until you cash in the bonds at which time you may be in a lower tax bracket.

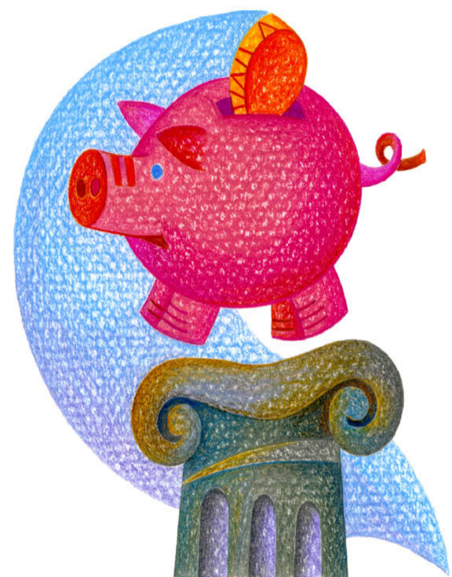
The opposite may be true for your child's U.S. Savings bonds. When your children cash in the bonds, they'll probably be in a higher tax bracket than they are in now. However, a child can elect not to defer the tax on the interest. When the interest is reported each year, it can be sheltered by a child's $1,000 exclusion.

Marketing Tips

What Makes a Quality Sales Force

In a recent survey of 13 industries, Sales and Marketing Management asked 1,000 top executives what they consider to be the extremely important characteristics of a quality sales force. Here are the results:

Characteristics	% Saying Extremely Important
Reputation among customers	66%
Holding old accounts	62%
Opening new accounts	47%
Quality of training	46%
Ability to keep top salespeople	45%
Innovation	35%
Product/technical knowledge	34%



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A Better Way to Handle Merit Pay Increases (continued)

Obviously such an employee doesn't deserve a merit increase as much as another worker who performs important tasks exceptionally well and less important tasks not quite as well.

As an example of how this plan can work, here's a rating system that might be applied to a data entry clerk. Note how this job is broken down into four separate tasks and how each task is given a performance rating.

- Entering 200 records a day is the most important aspect of this job and is rated at 60%.
- Entering data at a 95% accuracy rate is less important and is rated at 20%.
- Checking the daily work of a co-worker is even less important and is rated at 10%.
- Training new workers is also less important and is rated at 10%.

Now let's assume that the employee must have an overall rating of 90% to be eligible for a merit raise. If the worker averages 240 entries a day (20% more than expected), the employee's rating for that task is 72%. If the worker's data entry accuracy is 85% (less than the expected 95%), the worker gets a zero rating for that task. If the worker performs at the expected level for each of the last two tasks, another 20% is earned. This would give the clerk a total rating of 92%, which qualifies for a merit increase.

For this system to work, the ratings must be based on performance for an entire year. Supervisors must evaluate and record an employee's performance rating each month. In addition, the rating system must be clearly explained to employees. When employees understand how they are being rated, the system will motivate them to achieve the ratings that will earn them merit increases. If the rating system isn't clear, it will have little or no effect on employees motivation.

How to use bonuses

One of the biggest drawbacks to merit pay increases is that supervisors may tend to inflate employee ratings regardless of actual performance. This can qualify too many employees for merit increases and cause payroll costs to increase rapidly. To avoid this problem, determine a fixed amount which can be spent on increased compensation. Then distribute that amount based on performance, making certain that only the best employees get a maximum increase.

Even worse, if a company has a poor year, it's almost impossible to reduce salaries accordingly. For example, over a ten-year period, compensation costs might rise 60% while sales might increase by only 12% because there were no pay reductions in the years when sales were down.

Controlling steadily increasing payroll costs is best handled by bonuses to exceptional workers. The same rating system used for merit raises can be used to determine which employees get bonuses. However, don't make bonuses automatic. Instead, establish overall company goals that must be met before employees can be eligible for bonuses.

Because bonuses are a non-recurring expense, they are particularly attractive to companies where sales fluctuate from year to year or where sales are difficult to forecast. In addition, bonuses motivate workers who might not be eligible for merit raises because they have reached their maximum salary level.

Tax Tip

Manufacturer's Deduction

Businesses that manufacture goods in the United States can claim a deduction based on production activities and taxable income (for corporations) or adjusted gross income (individuals). Those eligible for the deduction – "domestic producers" – include not only traditional manufacturing companies, but also those in construction, engineering, energy production, computer software, films, and processing of agricultural products.

The deduction is 9% of the lesser of qualified "production activities income" or taxable income. This will have the effect of reducing the top corporate and individual tax rates by approximately 3%. **Added benefit:** The deduction will apply for AMT as well as regular tax purposes.

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