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

Using Your Family to Lower Your Taxes

Tax Points

The Unbreakable Rules of Successful Money Management

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

Unpaid Withholding Taxes Can Mean A 100% Personal Penalty

When Home Construction Interest is Not Deductible

Using Your Family to Lower Your Taxes

It's possible to realize substantial tax savings by shifting income from family members in high tax brackets to family members in low or zero tax brackets. These are the best strategies.

Make the Kiddie Tax work for you

Under the so-called Kiddie Tax, the investment income of a child is taxed at the parents' maximum tax rate. You can side-step the tax by taking advantage of some loopholes in the law.

- Only the portion of a child's investment income which exceeds $2,100 a year is taxed at the parents' top rate. The first $1,050 of a child's investment income is tax-free, and the next $1,050 is taxed at the child's own rate. Therefore, you can save taxes by giving your child assets that produce up to $2,100 a year.... for example, a $40,000 investment that pays a 5% dividend. Your child's taxes on the $2,000 investment income will be considerably lower than the taxes you would pay on the same income.
- Because the Kiddie Tax does not apply to earned income, you can hire your child to work in your business and deduct the cost of the child's wages at your maximum rate while your child's income is taxed at the child's lower rate. Furthermore, up to $6,300 in earned income of a child is tax-free. The Tax Courts have ruled that reasonable salaries paid to children under age 14 for routine tasks at a parent's business (including a sideline business) are deductible. **Extra bonus:** If a family business is not incorporated, there are no Social Security taxes on wages paid to a child who is under age 18.

CONTINUED ON PAGE 4

*tax*POINTS

Living trust may be an estate tax trap. These trusts are often used to avoid assets from going through probate. However, trust assets can be taxed and the IRS has three years to audit an estate return. The trustee for the deceased can be held personally liable for tax liabilities owed if an IRS audit is completed after the trust distributes its assets. Should the beneficiaries not return assets then the trustee might have to pay the tax from their own funds.

Review your personal carryovers from one year to the next. Investment interest paid in 2015 that is not deductible because you had insufficient investment income to offset it is carried over to 2016. You could arrange to receive investment interest now that will shelter it from tax. At this time, you should also check loss carryovers from businesses and charitable deduction carryovers that may affect the amount of new charitable contributions you can deduct in 2016.Finally, unused realized capital losses from 2015 can be used to offset capital gains that are realized now.

Contribute to your 401(k) plan. For 2016, you can contribute up to $18,000. You pay no current taxes on the money contributed to the plan, and the income that is earned on the money contributed is also exempt from current taxes. An individual who is at least 50 years of age may make an additional "catch-up" contribution of up to $6,000.

The Unbreakable Rules of Successful Money Management

There's no real secret to managing your money wisely. With a little discipline, you can protect your money and maximize its growth by sticking to a few basic investment principles. Here are the most important.

- **Never invest in anything you don't understand.** You wouldn't buy a book written in a strange language and you shouldn't put your money in anything you don't understand completely. If you don't know all the details about what your money is buying, look elsewhere.
- **Don't make snap judgments.** Just because your brother-in-law made a fast profit on a new high-tech stock doesn't mean it's for you. Your situation and your risk tolerance are unique. *Think* before you invest.
- **Diversify.** It's a common money management mistake to put all your funds in one place. You can substantially reduce your risk and improve your profit potential by dividing your money among fixed income investments, equities, and cash. Always diversify, no matter how much money you have to invest.
- **Be patient.** Don't buy stocks or mutual funds and expect big profits in a few months. It often takes years for an equity investment to pay off. Buying and selling stocks over the short term is almost always bad money management.
- **Don't invest just to save taxes.** You might save taxes but wind up *losing money*. Tax-free investments invariably pay less than other investments. Consider your total *after-tax return* before you invest.
- **When you make a profit, take it.** If you buy a stock, pick a price at which you'll make a satisfactory profit. When the stock reaches that price, *sell*. Remember, stocks go *down* as well as up and there's no guarantee that a rising stock will continue to go up.
- **Ignore hot tips.** They're almost always wrong no matter how convincing or well-meaning your source is.
- **Always keep track of your investments.** Monitor your investments at least once a month. It only takes a few minutes to look in the newspaper or call your broker. Unpleasant surprises should be and can be avoided.
- **Read the fine print.** CDs carry a substantial penalty for early withdrawal. High money market interest rates may apply only for the first few months your money is invested. And there's a big difference between interest rates and effective annual yield.

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.

CONTINUED FROM PAGE 1

Using Your Family to Lower Your Taxes (continued)

- You can avoid the Kiddie Tax entirely by investing in assets that appreciate in value instead of assets that yield current income. When your child is no longer subject to the Kiddie Tax, appreciated assets such as real estate and growth stocks can be sold and the profits will then be taxed at the child's low rate.

Residential real estate: the best family tax shelter

Residential real estate can be one of the most productive tax shelters available when you use your home or the home of another family member to shift income.

The basic principle. When you rent a home or apartment to another person, you become a landlord and can take rental deductions for the property. You can use deductions such as depreciation, insurance, utility expenses, and maintenance costs to shelter your rental income from tax. And because depreciation is not an out-of-pocket cash expense, you may actually have a deductible net rental loss even though the real estate is generating a positive cash flow.

The rules. To get these tax breaks, you must actively participate in the management of the property, which means establishing the rent, finding a tenant, etc. Your deduction for losses from residential real estate is limited to $25,000 if your Adjusted Gross Income (AGI) is less than $100,000. The $25,000 deduction is phased out for AGIs between $100,000 to $150,000 and no deduction is allowed if your AGI is over $150,000. However, disallowed deductions can be carried forward and can be used to offset your gain from a future sale of the property.

You can take advantage of these tax breaks even if you rent to family members as long as they pay a fair rent, which does not necessarily have to be a fair market rent. Because renting to family members involves less risk than renting to strangers, one Tax Court has ruled that family members may be given a rent discount.

Family residence strategies

- **Extra cash for retired parents.** You can buy your parents' residence on an installment sale basis and then lease it back to them. If your installment payments are greater than your parents' rental payments, your parents have an extra cash income each month. You can afford this cash outflow because of the tax shelter benefits you get as the owner of the property. In addition, your parents' estate tax liability is reduced because the property is no longer part of their estate.
- **Renting part of your home.** You can rent part of your own home to your parents or other relatives. The portion you rent qualifies as rental property and, as long as you charge a fair rent, you can take all the deductions that are attributable to the rented portion.
- **Reducing the cost of college housing.** Housing costs for children at distant colleges can be very expensive, but if you buy an apartment and rent it to your child and your child's roommates, you can create a valuable tax shelter. And in some areas, the apartment could increase in value by the time the child graduates.

Another way to shift income

If you have a profitable family business, look into setting it up as an S corporation. You can then distribute shares among family members. Since income from an S corporation is taxed directly to its shareholders in proportion to their holdings, you can shift income to lower-bracket family members by transferring shares of stock to them.

Using family members can lower your taxes, but check with your accountant before deciding on a course of action.

Tax Tip

When home construction interest is not deductible.

The rule that prohibits a deduction of personal interest generally does not apply to "qualified residence interest". But don't assume that interest on a residential construction loan is automatically deductible.

For example, if you use your savings account as security for a construction loan, the IRS considers the interest you pay on the loan to be personal interest which is not deductible.

For residential construction loan interest to be fully deductible, the loan must be secured by a taxpayer's principal or secondary residence. If the loan does not exceed the adjusted basis for the property, the interest is then fully deductible as qualified residence interest.

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