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CLIENT'S tax & financial UPDATE

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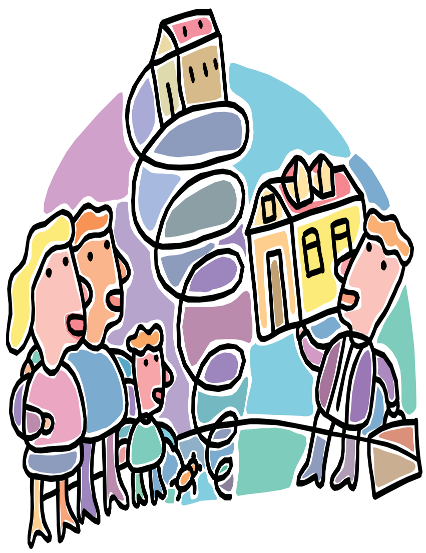
A tax, business, and financial planning newsletter for our clients and friends

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 $1,900 a year is taxed at the parents' top rate. The first $950 of a child's investment income is tax-free, and the next $950 is taxed at the child's own rate. Therefore, you can save taxes by giving your child assets that produce up to $1,900 a year....for example, a $36,000 investment that pays a 5% dividend. Your child's taxes on the $1,800 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 $5,700 in earned income of an under-age-14 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.
- 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.

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*tax*POINTS

Loophole: Sell securities short against the box. This is a way to lock into a gain on a stock at current prices and put off the payment of the tax on that gain until the following year. The strategy is made even better if you anticipate the price of the stock to fall before the end of the year.

Pitfall: Transferring money from a company pension plan to an IRA. Transfers to an IRA must be completed within 60 days to avoid tax. If more than 60 days pass before you make the transfer, the entire amount is taxable as income, and if you are not age 59-1/2, there is an added 10% penalty.

Gifts. These are tax free to recipients. Gift makers incur no tax cost on gifts up to $13,000 per recipient each year ($26,000 when gifts are made jointly by a married couple.) In addition, gift makers have a $1 million lifetime gift tax exempt amount.

Gifts can reduce income tax by shifting income-producing assets to family members in lower tax brackets, and reduce future estate tax by shifting assets out of an estate.

Employer provided tax-free fringe benefits and "perks." Employers can provide a wide range of tax-free fringe benefits that effectively provide employees with tax-free income.

Examples: Employer matching contributions to 401(k) savings…group term life insurance coverage up to $50,000…disability insurance…flexible spending accounts into which employees can deposit a pretax portion of salary to pay for medical or dependent-care costs…employee discounts on products or services.

How To Use Productivity Ratios To Judge Company Performance

Keeping track of ratios is a simple and useful way to determine whether a company's costs are in line with its productivity. Here are some important ratios to watch.

- ***Number of employees to sales volume.*** Sales dollars per employee should be tracked on a regular basis. If sales per employee decrease, you may be losing market share, or your production methods may need improvement.
- ***Profit margins to sales by product.*** This ratio can help to identify weak product lines and determine where price increases or product changes are necessary.
- ***Net sales to current assets.*** By tracking this ratio, you can test various strategies to maximize sales dollars relative to current assets.
- ***Direct cost of materials to sales.*** Changes in this ratio will alert you to look for cost increases in areas such as raw materials. When these areas are identified, you can take steps to correct them.

Tips For Better Negotiating

1. **Negotiate on your opponent's premises.** This will eliminate the interruptions and distractions at your own office. It also lets you evade a tough question since you can claim that the information you need is at your office. In addition, you can ask to speak with your opponent's superior if you reach a stalemate.
2. **Listen while you talk.** It will tip you off about what negotiating points you should follow up on.

   

   A sigh, a grunt, or a murmur of disagreement can often provide valuable information you can put to good use as the negotiations proceed.
3. **Don't be tricked into a last minute concession.** When you think your negotiations are completed, watch out for unexpected tactics. They're usually preceded with statements such as "by the way, it's only a detail but…" or "this means we get this-and-so, too." If it's obvious that the other party is looking for more than you've both agreed to, calmly say that you'll look into it and the chances are that the other side will drop the matter.

When Increasing an Expense Account Is Better Than a Raise

Increasing business expense reimbursements can have better after-tax consequences for both the employee and the company.

A salary increase is, of course, fully taxable to the employee. Furthermore, allowable deductions for personal business expenses that can offset a salary increase have been greatly reduced by tax law changes.

For example, interest on consumer loans such as credit card charges and automobile loans is no longer deductible. Also, only 50% of the cost of business meals is deductible. In addition, the employee deduction for business expenses that are not reimbursed is limited to the amount by which the employee's total miscellaneous expenses, including business expenses, exceed 2% of Adjusted Gross Income.

Expenses reimbursed to an employee which are included in the 2% limitation of Adjusted Gross Income are fully deductible to the company. So, if the employer reimburses the employee for these expenses, the after-tax cost of these expenses to the company is reduced and the employee is not taxed on the reimbursement. In addition, the company avoids paying employment taxes on increased salaries.

Adjusting salary and expense reimbursement levels to minimize after-tax costs can make an increased expense account better than a salary raise.

Charity Deductions

To claim a charity deduction you must make donations by year-end and obtain necessary documentation to support them. This documentation can be:

- **An acknowledgement letter** from the charitable recipient for all gifts larger than $250. A canceled check is not enough.
- **An appraisal** of any donated property valued at over $5,000.

Social Security Tax Exemptions

The maximum income from salaries and wages which is subject to Social Security tax keeps going up. For 2010, many taxpayers will pay more Social Security tax than ever before.

There are, however, several kinds of payment which are not subject to Social Security tax. Here are some examples.

- Social Security benefits payments are exempt from Social Security tax, although they may be subject to income tax depending on your total income.
- Company loans to a stockholder or an employee are not subject to Social Security tax, but documentation showing that the loan will be repaid must be available. If the IRS decides that the loan will not be repaid, it can impose Social Security tax on the amount borrowed.
- Wages you pay to your under-age-18 children are also exempt from Social Security tax, but only if your business is a sole proprietorship. If your business is a corporation, all wages are subject to Social Security tax.
- Fringe benefits are not subject to Social Security tax. Typical examples of exempt fringe benefits include employer-paid health insurance premiums and employer contributions to qualified retirement plans.
- Payments received that are not compensation for services rendered are exempt from the tax. Such payments include interest, dividends, rents, pensions, inheritances, and gifts.

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Using Your Family To Lower Your Taxes

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 business 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.

Cutting Costs

Finding waste.

You have to know what is waste before you can eliminate it. Most people will get rid of waste when they recognize it, but the first step is to identify it. Once that's done, the problem of waste will usually take care of itself.

Cutbacks can be costly.

Too often, work done by terminated employees is transferred to those who remain after the cutback. The new heavier workload can overburden well-qualified employees so that the company is actually in worse shape than it was before downsizing.

Avoid this costly trap by eliminating work at the same time you cut back your work force. Give special attention to tasks that can't be transferred to employees whose wages are the same or lower than the dismissed employees. Assigning clerical chores to managers not only hurts morale, but actually increases costs.