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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

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How To Cut Overhead Costs for A Better Bottom Line (part 2)

As we noted in our last issue, the best way to prevent overhead costs from eating into profits and causing serious cash flow problems is a healthy dose of preventative medicine. A regular monthly review of overhead costs will help you pinpoint problems before they get out of hand. Assigning responsibility for each area that generates overhead costs to one individual will let you meet with the person in charge of a problem area to discuss the reasons why overhead costs are increasing and determine what can be done to bring them under control.

Personnel management

Wages and salaries are a major portion of monthly overhead. If each payroll dollar doesn't bring an adequate return, overhead skyrockets. Personnel management is often the problem because payroll leaks are actually time leaks. Improper scheduling, for example, can cause slack periods during which employees are not producing but are still being paid. Casual attitudes about starting and quitting times, coffee breaks, lunch hours, and personal time off can result in shrunken work days and weeks.

Frequently inflated personnel costs are simply the result of too little work for too many employees. As one widely quoted business consultant put it, "always hire too few employees".

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taxPOINTS

Succession planning loophole. Sell your business on an installment plan. This freezes the value at the current price. The seller reports capital gain on the installment basis, delaying taxes because gain is recognized only when and to the extent that installment payments are received. Interest must be added to the payments. The purchaser's note will be included in the seller's estate and the unpaid balance (the remaining portion of the capital gain), even though not yet received will be subject to income tax upon death.

Bonus depreciation. Under the law, businesses are entitled to claim 50% bonus depreciation for eligible new property placed in service in 2012. This means that half the cost of the property can be deducted in the first year, along with any additional depreciation on the other half of the property's cost, as well as any first-year expensing.

Business use of personal cars. If you drive your personal car, truck or van for business, you can deduct the operating expenses related to business use. There are two ways to do this…**Actual expense method.** You can deduct your actual expenses related to business use of the vehicle – gasoline, oil, tires, repairs, insurance, etc. – plus an allowance for depreciation. **Standard mileage rate.** Deduct business driving in 2012 at the IRS rate of 55.5¢ per mile. This cents-per-mile allowance takes the place of actual expenses.

Insurance As An Investment: Features and Drawbacks

Insurance companies offer a wide variety of investment-oriented products. The following summary will give you a general picture of the most popular of these products. Keep in mind that insurance investment vehicles can be quite complex and it's wise to seek out a knowledgeable agent who can help you pick the investment that's best for you.

Single premium whole life insurance

As its name implies, you buy this policy with a single lump sum payment. The amount of life insurance you get is a multiple of that payment. The younger the insured, the higher the benefit amount will be. The policy grows as long as it stays in effect. It can be used to pay a non-taxable sum to beneficiaries immediately upon your death. Single premium whole life should be considered only as a long-term investment.

Single premium variable life insurance

This insurance is somewhat similar to single-premium whole life, except that because you can choose to invest in any of several different mutual funds, your principal is not guaranteed. The best mutual funds to invest in are those with long-term growth potential.

Universal life insurance

Universal life insurance guarantees your principal, but the interest you earn fluctuates and is determined by the insurance company. You pay periodic premiums which can be fixed or flexible. Universal life insurance is a good way to establish a regular investment program and is a good source of emergency funds because of its loan features.

Universal variable life insurance

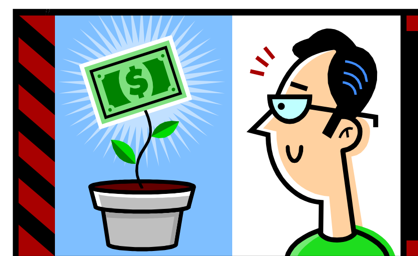
Universal variable life is similar to universal life with two important exceptions: you choose where your money is invested, and for that reason, your principal is not guaranteed. Expenses are often high and the best use of universal variable life is as a long term investment to accumulate wealth for your heirs.

Fixed annuities

Fixed annuities do not provide life insurance coverage, but their cash value build-up is tax deferred. You can pay premiums periodically or in a lump sum and your principal is guaranteed. A fixed annuity is a good retirement supplement if you can no longer make tax deductible contributions to a qualified retirement plan such as an IRA or a Keogh Plan. Distributions made before you reach age 59 ½ are subject to a 10% penalty.

Variable annuities

Variable annuities have the same features as fixed annuities except that you can choose to invest in any of several mutual funds. Because expenses are relatively high, a variable annuity is usually best for an active knowledgeable investor.



How To Avoid Double Taxation

One of the most important reasons why businesses incorporate is to save taxes. The first $50,000 of corporate taxable income is taxed at a rate of 15%, while the individual income of the business owner is almost always taxed at a higher rate. For example, if a taxpayer has income that is taxed at a 35% individual rate, shifting the income to the taxpayer's corporation will reduce taxes by over half.

That's why Fred Swift incorporated his business when he founded it. Fred owns Swift Transportation, Inc., a successful trucking business that's wheeled along the road to steady profits year after year.

Fred is in business for the long haul and has always steered his finances in a conservative direction. To Fred, the best route is to concentrate on profits and a strong cash position so he won't have to worry about paying the company's bills on time. To do this, Fred paid himself a salary that was less than Swift Transportation earned, and he made certain that there was always enough cash on hand for the company to operate smoothly.

Swift Transportation delivered solid results for the year ending December 31, 2011. The company was running in high gear and its cash position had never been better. After all deductions, including Fred's salary of $90,000, the business earned $40,000 in taxable income. Based on 2011 corporate income tax rates, the company paid federal income taxes of $6,000 and had more than enough cash to continue its well-tuned operations.

After the 2011 results were in, Fred realized that the business had accumulated surplus cash beyond its forseeable needs. So in 2012, he increased his salary by $40,000 – the taxable income that the company earned in 2011. Naturally, when Fred files his 2012 individual income tax return, Fred will pay income taxes on his $40,000 salary increase. That means the $40,000 will be taxed twice – first as 2011 corporate earnings and again as part of Fred's 2012 personal income.

That's called Double Taxation, an unwelcomed burden to any taxpayer who owns a business.

A BETTER SOLUTION

Fred's conservative cash strategy backfired because he didn't shift gears soon enough. Fred should have realized that the business was accumulating too much cash and should have raised his salary from $90,000 to $130,000 in 2011 instead of 2012. He would then report his salary increase on his 2011 individual income tax return, but the corporation would pay zero taxes for 2011 because Fred's salary increase would be deducted from the company's earnings. That's a corporate tax savings of $6,000.

The $40,000 would then be taxed only once and Fred would have brought Double Taxation to a screeching halt.

Long-Term Care Insurance

Depending on your age, some of the premiums you pay may be deducted on your income tax return.

Age Before Year-End	Maximum 2012 Deduction
40 or under	$350
41-50	$660
51-60	$1,310
61-70	$3,500
71+	$4,370

How To Borrow Interest-Free From Your IRA

The rules for taking money from an IRA are quite clear. Any amount you withdraw is subject to income tax in the year in which the money is distributed to you. If you receive distributions before you reach the age of 59 1/2 (except for special exceptions), those distributions are subject to a 10% penalty.

However, one little-known exception to these rules allows you to withdraw any amount you wish from your IRA tax-free and penalty-free. In effect, you can use your IRA as your own private loan company and borrow from it without paying interest.

Be very careful, however, because you must return the funds to the IRA from which you withdrew them or you must rollover the withdrawn funds into another IRA within 60 days of the date you withdrew the money. Furthermore, you can only "borrow" from your IRA once a year using this technique.

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How To Cut Overhead Costs For A Better Bottom Line (part 2)

Security

Losses from employee dishonesty are another form of hidden costs. Security control begins on paper: a written record of all cash and inventory not only shows what is supposed to be where, but it also is a deterrent to dishonest employees. However, the most effective curb on employee dishonesty occurs at the hiring level when all references should be checked out as a condition of employment. Failure to check references is the most common security lapse in the business world.

Employee advances and loans

In many companies, there is a healthy amount of cash floating around among employees because of poor controls over advances for travel and entertainment expenses. So "loans" from petty cash and personal withdrawals by the owner (sometimes unrecorded) can also add up to a substantial sum.

Proper record keeping can eliminate these cash drains. Records should show how much is outstanding and for how long. A review of the company's policies might be in order. For example, some companies won't advance travel and entertainment expenses until the previous month's expenditures have been documented.

Insurance

Insurance needs can change over time and a regular review of coverage and costs can often uncover potential savings. Comparison shopping, for example, might uncover a more efficient insurance package from another agent. Or the discovery of record keeping errors might result in a premium reduction.

If cash is scarce, insurance premiums can be paid on a monthly schedule rather than in quarterly or semiannual installments, thus making cash available for other purposes.

Special customer services

Building goodwill by offering special services often carries hidden costs. For example, it costs money to warehouse merchandise for customers, or to produce special colors, or to deliver beyond normal limits. When a business calculates what these extra services actually cost - both in time and material - it may become apparent that an extra charge should be made for some of these services.

Tax Tips

Credit card settlements

People with large credit card debt sometimes are able to settle for less than the full amount owed. If someone owes $25,000 and settles the debt in full for, say $8,000, the $17,000 difference is taxable income.

Loophole: This income is not recognized for tax purposes if the debt relief is part of a personal bankruptcy settlement or if the debtor is insolvent immediately before the debt cancellation.

Even in those situations, the lender will send a Form 1099-C, *Cancellation of Debt*, to the IRS reporting the cancellation of debt as income. To avoid tax, you must complete and attach Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness*, to your tax return.

Long-term-disability insurance payments

Some employees who become disabled receive payment under an employer-provided disability policy. These policies are often included in compensation packages as a tax-free fringe benefit. Other companies have cafeteria plans offering an array of benefits, including disability insurance, that employees must choose from. The tax treatment of these benefits depends entirely on who paid the premiums…

If the employer paid, benefits are taxable.

If the employee paid, benefits are tax free.

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