

TAX & BUSINESS STRATEGIES

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Thinking About Incorporating?

The decision on whether or not to incorporate involves a number of complicated issues. All too often, taxpayers make unwise decisions based on misconceptions of tax benefits available to corporate entities. It is not uncommon at social gatherings to overhear someone talking about incorporating in order to write off this or that. Generally, there is little difference between expenses that are deductible as an individual doing business versus that of a corporation. Although there are some benefits associated with corporations, there are also corresponding negatives. Corporations can take two forms, either a C-corporation or an S-corporation. To gain some insight into the differences between doing business as a corporation or as an individual, let's review some of the major issues:

Limited Liability – A corporation is an entity unto itself. The shareholder owns an interest in the corporation itself but does not own an interest in the corporation's individual assets. Except in unusual circumstances, a shareholder's liability is generally limited to his or her investment in the corporation. This is a distinct advantage over an individual doing business, in which both the business and personal assets are at risk.

Double Taxation – Generally, the only way money can be taken out of a corporation is via a reasonable salary, through dividends paid by the corporation, or reasonable interest on stockholder corporate debt. The wages and interest are both deductible to the corporation, but the dividends are not. Thus, there is a potential for double taxation: the stockholder pays individual income tax on the dividends received but the corporation is not allowed to deduct the dividends paid as an expense. If the corporation has a loss for the year, the stockholders (except for S-corporation stockholders) receive no benefit. In contrast, an individual doing business reports on his or her personal tax return the business' overall gain or loss for the year, and there is never any risk of double taxation. In addition, the individual benefits from a deduction against other income if the business has a loss for the year.

Employee Fringe Benefits – There are a number of fringe benefits available to corporate employees that are not available to or are significantly different for individually-owned businesses. Some of the more popular benefits include pension/profit-sharing plans, group life insurance, group health insurance, disability income coverage, medical reimbursement plans, cafeteria plans and education reimbursement plans. However, shareholders/employees of S-corporations do not receive the full range of tax-free fringe benefits that are available to those of a C-corporation.

Selling the Business – Generally, selling an individually-owned business involves putting up for sale the various pieces that make up the business such as equipment, real property, goodwill, etc. The business owner is taxed on each piece based on the remaining cost in

Dear Client:

With the 2005 tax year fast approaching, it's time to get all your planning and preparation in gear. This edition offers different tax strategies to help you manage your investments wisely and reduce this year's taxable income.

This issue also discusses the pros and cons of incorporating and offers a few tips for business owners trying to maximize their tax deductions. One way to turn your high-taxed income into tax-free or low-taxed income is to have your children work for you on a part-time basis or during the summer. Please call our office for more information on the rules about employing children.

You will also find some investment tax tips to help increase the after-tax return on your investments. The last thing you need at tax time is to pay taxes on investments that you didn't expect. Make sure that you evaluate your portfolio on a regular basis and contact our office if you have a specific tax concern.

Don't miss the opportunity to reduce your tax burden by not planning ahead. We offer year-round tax planning services and can help you make the most of available tax strategies.

We look forward to assisting you with your tax needs.

(Continued inside)

Investment Tax Blunders to Avoid

We realize that a mid-year review of your tax situation may not be at the top of your “to-do” list, but think of it this way: devoting a few minutes now could save you big bucks at tax time.

By following these tips, you can possibly reduce your taxes for the year and even increase the after-tax return on some of your investments:

1. Anticipate distributions from declining funds – Since mutual funds are required to distribute capital gains to shareholders, you might receive a taxable distribution even though there was a decline in the share price of your fund this year. By preparing yourself and setting aside cash, you can avoid scrambling to pay taxes in April.

2. Purchase shares after the next scheduled distribution – Don’t buy a mutual fund shortly before a capital gains distribution since a portion of your investment will almost immediately be handed back to you. This will have you owing tax on the distribution with less money to reinvest.

3. Be prudent with “tax-exempt” investments – Although the income from “tax-exempt” investments is generally nontaxable, funds will sometimes throw off capital gains distributions. This happens when the fund managers sell bonds, which can produce a taxable capital gain, and then buy other bonds. This can aggravate fund investors who don’t expect to pay taxes on these types of investments.

In addition, if you want the income to be tax-exempt for state income tax purposes, you need to make sure the fund is invested in your resident state muni-bonds since most states treat as taxable muni-bond interest derived from other states. Another common mistake is failing to change funds when you move from one state to another.

If you are subject to the alternative minimum tax (AMT), be aware that interest from “private activity” muni-bonds is tax-exempt for regular tax purposes but not for AMT purposes.

4. Time your fund transfers wisely – Frequently, people sell one bond fund to buy another as a way of rebalancing their portfolio. However, for tax purposes, that represents a sale of a security and the purchase of another. Thus, you will need to account for the gain or loss from the fund sold on your tax return. This is generally an unpleasant surprise to those unaware of this rule, especially if there is significant gain to report on the sale. If there is a loss, selling it during the current year will allow you to utilize the loss now. However, if there is a gain, consider waiting until just after the first of the year so that you can defer the gain.

5. Contribute the maximum – If you maximize your retirement plan contributions, it will help maintain your current lifestyle years from now. In addition, it may also reduce this year’s taxable income.

6. Sell a loser – There probably isn’t a stock market investor who isn’t holding a stock that is worth less now than when it was bought. Selling a loser in a taxable account can save you money and free up cash for investments with more potential. This is because the IRS allows investors to offset realized gains with realized losses. In addition, \$3,000 in additional losses can be used to reduce your taxable income. Don’t sell for tax reasons alone, especially if you are confident that your dogs will turn into dream stocks. Just keep in mind that if a stock has dropped in price by 50%, it will need to gain 100% in order to break even.

7. Be aware of the limit on losses – If you are thinking of cashing in all your dogs, consider that losses are limited to offsetting realized gains and up to \$3,000 in ordinary income. Although losses higher than this amount can be carried over for use in the future, they would be of no benefit to you this year.

8. Stay away from wash sales – If you would like to offset gains with losses, try and avoid “wash sales” since the IRS doesn’t allow you to recognize the loss on such sales. A wash sale occurs when a security is sold at a loss and then repurchased within 30 days before or after the date it was sold.

Don’t fret. One way you can realize losses and keep your portfolio balanced is to sell and buy back a security 31 days after the sale. Individuals who cannot wait for that period of time should purchase a similar security (not identical) to the one that was sold.

9. Check your cost basis when you sell – Although most people remember to include commissions on trades or mutual fund transaction fees when calculating cost basis, many fail to consider the dividend money that has automatically been reinvested, which results in taxpayers overpaying on taxes. The most common type of dividend reinvesting occurs when a mutual fund shareholder automatically has their dividends reinvested in more shares of the fund. However, some publicly-traded corporations also have dividend reinvestment plans for individual stockholders. Reinvested capital gains and dividends can add quite a bit to cost basis and make gains much smaller.

Review all your purchases when it comes time to sell. You will have a smaller taxable gain and a much better idea of your actual return on a fund.

As an investor, you want what’s best for your money. Be prepared and avoid the unnecessary headache at tax time. If you have specific concerns regarding your investments, please call our office so we can discuss them in detail.



Thinking About Incorporating? (Continued)

that item and can sometimes take advantage of the lower capital gains rates. This is also mostly true for S-corporations that sell off the pieces of the business rather than the stock, since they are "pass through" entities. For a corporation, the business can be sold by simply selling the shares of stock to a buyer, resulting in a capital gain (or loss) to the seller. However, in most cases, the buyer prefers an asset purchase, which provides better up-front write-offs and avoids assumption of any prior corporation liabilities. When this happens, the sale of the asset is taxed at the corporation level and will generally be taxed again at the personal level in the form of a dividend, salary or liquidation.

Administrative Costs – Establishing and maintaining a corporation can be costly. Normally, a lawyer handles the filing of the Articles of Incorporation and states charge for issuing corporate charters. In addition, the corporation must pay yearly fees to maintain its charter and conduct its business. The corporation must maintain a list of all the shareholders and hold at least one shareholder meeting per year, both of which add to its corporate expenses. In contrast, the business operating as an individual does not have these expenses.

Avoid leaping into business structures until you have thoroughly educated yourself and reviewed your options, including exit strategies, retirement plan options, and a whole host of other considerations based on the type of business, business partners, potential liabilities, investment required, estate issues, etc. Please call this office before making your final decision.

Is Life Insurance a Sound Investment?

Most people don't look at life insurance from an investment perspective. However, it is becoming a popular option among corporations and trusts because it provides the best after-tax returns compared to other investment vehicles.

The easiest way to see what life insurance can and cannot do is to make a simple comparison with other investment options. Make sure that the comparison is fair and that all costs, including tax effects, are analyzed on a year-to-year basis for both the insurance and the alternative investment. Don't use investments that have completely different risk profiles; your comparison results will not be accurate.

If it is properly structured, life insurance can provide the following tax advantages:

- Your heirs will receive the death benefits tax-free.
- The cash values grow tax-deferred and any withdrawals are tax-free until the cumulative investment (in the contract) is recovered.
- A loan from the policy is not taxed as income.
- The death benefit will pay off any outstanding loan balances income tax-free at the time of death. The death proceeds can even be estate tax-free if the policy is owned by an Irrevocable Trust.

A life insurance program can be customized to meet your individual needs and objectives. If you are after the tax-advantaged cash value accumulation, you can minimize the life insurance benefit. In many cases though, the benefit is the most valuable feature since it immediately creates a capital sum at death that cannot be duplicated by any investment.

If you would like to discuss the tax benefits of a life insurance investment, please contact our office. Life insurance is a long-term proposition, but if you consider the returns on cash values available during life or the proceeds payable at death, it may be an appropriate investment for you.

Shift Business Income to Lower Taxes

If you have children that can work for you on a part-time basis or during the summer, you may be able to turn high-taxed income into tax-free or low-taxed income. It may even be possible to save on social security taxes and make retirement contributions for your child.

The work that the child performs must be legitimate and the compensation must be reasonable for your business to deduct the wages as a business expense. Take for example, a sole proprietor in the 35% tax bracket who hires her 16-year-old son to help with office work full-time in the summer and part-time in the fall. He earns \$5,000 during the year and has no earnings from other sources. Since her son can use his \$5,000 standard deduction for 2005 to completely shelter his earnings, the business owner saves \$1,750 (35% of \$5,000) in income taxes without costing her son a penny.

If the business owner keeps her son on the payroll for a longer period of time and pays him \$4,000 more, she could save an additional \$1,400 in taxes, and still not cause her son to pay any tax, provided he contributes \$4,000 to a traditional IRA. Even if her son's earnings exceed his standard deduction and IRA deduction, her taxes are cut because the unsheltered earnings will be taxed to the child, whose tax bracket starts at a rate of 10%.

The business will probably have to withhold federal income taxes on the child's wages. An employee is generally allowed to claim exempt status if he or she had no federal income tax liability in the previous year and does not expect any this year. Keep in mind that exemption from withholding cannot be claimed if:

- the employee's income exceeds \$800 and includes more than \$250 of unearned income (such as dividends), and
- the employee can be claimed as a dependent on another taxpayer's return.

When your child files a return for the year, he or she will probably receive a refund for part or all of the withheld tax.

By shifting some of your earnings to your child, you can also save some self-employment (SE) tax dollars if your business is not incorporated. This is because wages paid to the child are part of the business expenses and reduce your net income on which SE tax is based. However, you will not have a deduction for the employer's portion of FICA tax on the child's wages since you will not have paid this tax. Employment for FICA tax purposes does not include services performed by a child under the age of 18 while employed by a parent. A similar but more liberal exemption applies for FUTA, which exempts earnings paid to a child under age 21 while employed by his or her parent. Both the FICA and FUTA exemptions also apply if a child is employed by a partnership consisting solely of his or her parents.

In addition to the potential tax savings of bracket-shifting, your business may also be able to provide your child with retirement benefits. This depends on the type of plan your business has and how it defines qualifying employees.

Take into consideration that some of the rules about employing children change on a yearly basis, which may result in some strategy shifts as well. Please call our office to find out if these rules apply to your situation.

SEPTEMBER 15:

- Third installment of 2005 Individual Estimated Taxes due.

OCTOBER 17:

- Last date to timely file your 2004 Individual Tax Return (Form 1040) if you are in the United States and filed an extension with Form 2688.

SEPTEMBER - DECEMBER:

- Time for 2005 Year-End and 2006 Tax Planning. Contact this office to schedule a consultation appointment.
- Taxpayers who began their Minimum IRA Distributions before 2005 must withdraw their 2005 Distribution by December 31.

The purpose of this newsletter is to provide current information on tax, financial and business developments. It suggests general tax planning ideas that may only be appropriate when claiming tax benefits in a manner consistent with the statutes and Congressional purpose. The information and opinions are generalizations and may not apply to all taxpayers and cannot be used by a taxpayer for the purpose of avoiding penalties that may be imposed on the taxpayer. Therefore, it is important that you seek appropriate advice before implementing any of the ideas suggested.

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SINCE YOU ASKED...

YOU ASKED: I recently started a business. To minimize my up-front expenses, I decided to use furniture and equipment that I already owned. Which figure do I use as the business write-off? Should it be the original cost of the item or its current replacement value?

ANSWER: Unfortunately, neither. The fair market value (FMV) of the item at the date of the conversion must be used, provided it is less than your adjusted cost basis at the date of conversion. FMV is what a willing seller would pay a willing buyer if all the relevant facts are known to both parties. Generally, used furniture and equipment are worth less than their original cost, so FMV is likely the amount you will need to use. In addition, since you had already owned the property and used them for non-business purposes prior to converting them to business use, the special election to write them off in the first year does not apply. The property must be depreciated over its useful life.

YOU ASKED: I need to borrow \$30,000 to purchase equipment for my business. My loan broker suggested that I refinance my existing home

mortgage and take the \$30,000 out for the business. According to him, I will have the best overall interest rates by refinancing the first mortgage on my home. Is this a good strategy? **ANSWER:** The answer to your question is not a straightforward "yes" or "no." On one hand, refinancing the home and the business loan together, as your loan broker suggests, may provide you with the lowest overall interest rate and thereby save you money in interest payments. On the other hand, if you combine the business debt and home mortgage into one mortgage secured by the home, then all of the interest from that loan must be treated as home mortgage interest and none of it can be allocated as a deduction to your business. Also, if you are subject to the alternative minimum tax, part of the interest won't be deductible for the AMT calculation.

Business interest reduces AGI, and thereby increases the number of deductions and adjustments on your return that are limited by AGI. In addition, business interest reduces business profit itself, which reduces the self-employment tax. Therefore, it may be more beneficial to obtain a separate business loan. You could even use a separate loan that is secured by the home, such as a second trust deed. The law allows you to elect to have that loan treated as unsecured by the home and trace its use to your business. Finding out the best option for your specific situation requires a mathematical and tax benefit analysis. Please call our office for assistance.