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

CLIENT'S tax & financial UPDATE
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The Best Tax Shelter is Still Owning Your Own Business
Adoption Tax Loophole
Sale of Principal Residence
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The Best Tax Shelter is Still Owning Your Own Business

Owning your own business means that you make all the major decisions, including the ones that can have a real impact on your taxes.

One of the earliest and most important decisions you'll make is to choose the legal form your business should adopt. The most common forms are a sole proprietorship, a partnership, or a corporation. Each has different tax consequences and making the right choice can have a very positive effect on your tax picture.

Sole Proprietorships

A sole proprietor is an unincorporated business that has only one owner. It is a simple legal entity in which you are your own master.

A sole proprietorship has three major tax advantages:

- You can deduct any losses you incur from your business start up costs on your personal income tax return. These start up costs can be used to reduce your taxable income from other sources.
- You avoid double taxation. Income generated from a regular corporation is taxed twice. First, your business pays a corporate income tax on its profits. And then, as a shareholder, you pay personal income taxes on any dividends you receive from the corporation. On the other hand, income from a sole proprietorship is taxed only once - as income on your personal income tax return.
- Your overall tax burden may be less depending upon the tax bracket you are in.

Partnerships

A partnership is similar to a sole proprietorship with the exception that it has more than one owner. Each

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*tax*POINTS

Adoption tax loophole. The IRS allows you to take a tax credit for adoption expenses you may have paid up to a maximum of $13,400. This credit can be applied directly towards your tax. **Limit:** The credit is phased out for taxpayers who have modified adjusted gross income of between $201,010 to $241,010.

Gain from the sale of your principal house that you owned and occupied as a principal residence for at least two of the five years before the sale, you can now elect a $250,000 ($500,000 for joint filers) exclusion from gain on the sale.

An easy way to reduce your income taxes on investment income is to buy individual stocks rather than stock mutual funds. When you buy individual stocks and hold them, the only income taxes you would pay is from the dividends. With mutual funds, realized capital gains must be distributed and these capital gains distributions are taxable to the shareholders.

Boost Employee Morale During Cutbacks

When companies go through cost-cutting periods, they often focus all their attention on profitability and tend to ignore employee morale. In the face of cutbacks – which sometimes include layoffs – employee productivity suffers. Without employee understanding and cooperation, sales and profits may fall more rapidly than costs. Here's a checklist to follow to keep worker morale high.

- **Show employees the benefits they'll get.** If a little belt-tightening now means better job security later, make sure employees know it.
- **Explain why cutbacks are necessary.** When employees understand why cost-cutting is needed, they are much more likely to support cutbacks.
- **Ask for employee cost-reduction ideas.** When employees are actively involved in the decision-making process, they are more likely to understand and accept changes.
- **Tell employees when the plan is working.** Solid evidence that cost-cutting efforts are paying off will motivate continued worker cooperation.
- **Practice what you preach.** Be prepared to give up management perks and other privileges.

Sales Management Mistakes to Avoid

Don't set impossible quotas. Many managers automatically increase individual sales quotas every year so that sales people have to book more business before they can earn incentive income. This is a common approach to keeping costs down, but it can have an adverse effect on sales because salespeople become discouraged by quotas which are impossible to reach and may leave the company for greener pastures. If selling costs are a real problem, it's usually a better strategy to keep sales quotas realistic and offer lower commissions instead.

Don't limit income potential. Putting a ceiling on total sales commissions and bonuses tells salespeople that once they've reached the limit, there's no reason for them to continue to work for additional sales.

Don't waste sales ability. Good salespeople need new challenges. Selling the same customers over an extended period may make it easier to reach their quotas, but they soon realize that increasing their sales (and their income) is becoming more and more difficult. It's much better to reassign territories to provide new opportunities for salespeople to improve their income.

Hot Tax Breaks for College

The cost of education keeps going up faster than the rate of inflation, but Congress has created tax breaks to help with education expenses.

American Opportunity Tax Credit (AOTC).

This can be worth up to $2,500 per student.

The amount of the AOTC credit is 100% of the first $2,000 of education costs plus 25% of the next $2,000.

Limitations…

The credit is available only for the first four years of postsecondary education per student.

The student must be pursuing a degree or other recognized education credential and be enrolled at least half-time.

The credit is phased out as your modified adjusted gross income (MAGI) rises from $80,000 to $90,000 on a single return, and from $160,000 to $180,000 on a joint return.

Up to 40% of the credit is refundable. It can generate a refund greater than the amount of payments you made.

Lifetime Learning Credit.

This can be as much as $2,000 per tax return.

The credit equals 20% of the first $10,000 of education expenses (maximum credit per taxpayer regardless of the number of students).

The credit may be claimed for a student for any number of years.

The student need not be pursuing a degree and may be taking only one course.

The credit is phased out as your MAGI rises from $55,000 to $65,000 on a single return, and from $110,000 to $130,000 on a joint return.

Credit planning:

The AOTC credit and Lifetime Leaning credit can't both be claimed for the same student in the same year, but both can be claimed on the same return for different students (such as a child in college and a parent taking a work-related course).

Student-loan interest deduction.

This is available for up to $2,500 of loan interest even for those who don't itemize deductions on their tax returns. Loan origination fees are deductible, too.

Snag: Those who don't itemize often overlook this deduction.

The deduction is available for interest on a loan used to finance tuition, fees, room and board, books, equipment, and other necessary expenses (such as transportation) at virtually all accredited postsecondary and vocational schools.

Limit: The deduction is phased out as MAGI increase from $65,000 to $80,000 on a single return and from $130,000 to $160,000 on a joint return.

Coverdell Education Savings Accounts (ESAs).

Can receive up to $2,000 per year for any single beneficiary under age 18. ESAs earn tax-deferred investment returns which can be used tax free to pay education expenses.

Advantage: ESAs can be used to pay for elementary through high school, not just college.

To contribute to an ESA, one must have MAGI not exceeding $110,000 on single returns or $220,000 for married filing jointly. Anyone can contribute to an ESA for an individual, so if parents are unable to, a friend or other relative may contribute.

Qualified tuition programs (Section 529 plans).

These plans can hold funds that earn tax-deferred investment returns which can be spent tax free on college education costs. Or they can be prepaid tuition plans allowing a person to buy tuition now at today's prices.

Advantage: These plans can hold far more than ESAs and therefore can be used for estate planning. Yet a person who contributes funds to the plan can withdraw them in case of need – a unique instance of being able to "keep while giving away" under the Tax Code.

Tax-free scholarships, fellowships, and need-based grants.

These forms of aid generally are tax free when funds received are applied to tuition, fees and required course-related expenses (such as books, supplies, and equipment).

Beware: Funds applied to the cost of room and board, travel, or research are taxable.

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The Best Tax Shelter is Still Owning Your Own Business (continued)

partner's share of income, loss, and deductions is set forth in the partnership agreement. As in a sole proprietorship, these items are reflected on each partner's personal income tax return.

Partnerships have additional tax advantages:

- Income is taxed at each individual partner's personal income tax rate.
- You avoid double taxation because a partnership does not pay taxes.
- As a partner, you can deduct business losses to the extent that you are liable for obligations of the partnership. You can allocate losses differently than profits. If you provide most of the start up costs, you can take a larger share of the losses, even if the profits are shared equally by the partners. And the way you allocate profit and loss to each partner can be changed from year to year to accommodate changes in your personal circumstances.

"S" Corporations

An "S" corporation is a business that is formed under the rules of Subchapter S of the Tax Code.

Operating your business as an "S" corporation has several tax advantages:

- You may pay less taxes, depending upon the tax bracket you are in.
- You avoid double taxation. Your business profits are taxed only once, directly to you as a shareholder, on your personal income tax return.
- You avoid tax penalties on excess accumulated earnings. Since "S" corporation profits are taxed to stockholders even if they don't receive them, you can't be penalized for accumulated excess earnings in the business as can a regular corporation.
- You don't pay double taxes when your "S" corporation is liquidated. If a regular corporation is liquidated, the corporation is taxed on the gain and you and other shareholders are taxed on the portion of the gain which you receive. Since there are no corporate income taxes for an "S" corporation, you avoid double taxation when an "S" corporation is liquidated.

Regular "C" Corporations

Regular "C" corporations are a unique form of business. They are subject to a special tax structure and their earnings can be taxed twice, first at the corporate level and again when they are distributed to stockholders as dividends.

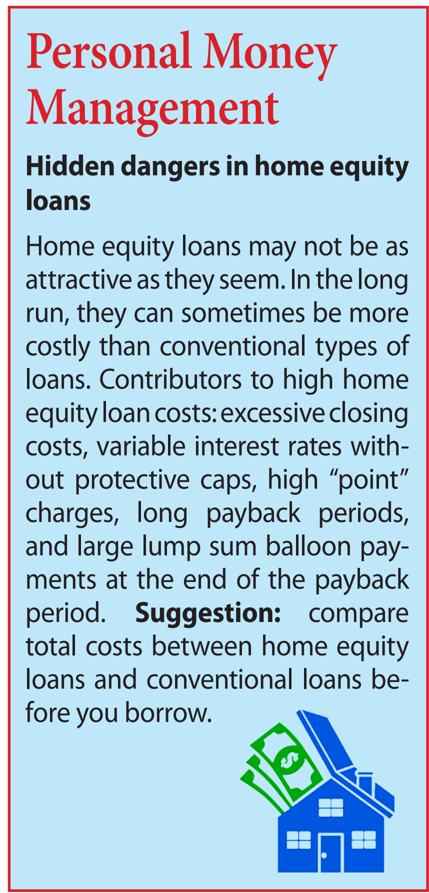
The double tax can be avoided by retaining earnings in the corporation rather than distributing them as dividends. This must be carefully planned, however, since the IRS can penalize a corporation for excessive accumulation of earnings. The penalty can be avoided only if a corporation can demonstrate that it has good business reasons for accumulating earnings.

Even if you own a small business, you can gain certain tax advantages from incorporating. For example, corporate tax rates on the first $75,000 of income are often lower than personal income tax rates.

Here's how corporate income is taxed:

CORPORATE INCOME	TAX RATE
$0 - $50,000	15%
$50,000 - $75,000	25%
$75,000 - $100,000	34%
$100,000 - $335,000	39%
$335,000 - $10,000,000	34%
$10,000,000 - $15,000,000	35%
$15,000,000 - $18,333,333	38%
over $18,333,333	35%

Your choice of a legal form for your business can have far-reaching consequences on your income taxes. It's best to consult your accountant before you make that important decision.



Personal Money Management

Hidden dangers in home equity loans

Home equity loans may not be as attractive as they seem. In the long run, they can sometimes be more costly than conventional types of loans. Contributors to high home equity loan costs: excessive closing costs, variable interest rates without protective caps, high "point" charges, long payback periods, and large lump sum balloon payments at the end of the payback period. **Suggestion:** compare total costs between home equity loans and conventional loans before you borrow.

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