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# CLIENT'S TAX & FINANCIAL UPDATE

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## Tax Points

A Tax, Business, and Financial Planning Newsletter for our Clients and Friends

# Celebrate the New Year by Cutting Your Taxes

**M**any people don't realize that sound tax strategies are part of a solid personal financial plan. So what's practical and effective for some taxpayers may not be the best strategy for others. However, regardless of your financial goals, it's important to look at possible tax strategies *now*, so you can generate tax savings for the entire year. Here are some of the best ways you can save tax dollars this year.

**1. First, look at the big picture.** Establish your investment goals and your insurance, education, and retirement needs. Make sure you understand the benefits that your company can offer you. Tax savings strategies will only make sense to you when you have a financial plan.

**2. Make your retirement plan contribution now.** Even if you can't take a deduction for your contribution, remember that the

money you put into the plan will compound on a tax deferred basis. Don't wait until the end of the year because you'll lose the benefit of compounding. Be careful however, that you won't need the money until you are age 59 1/2. Earlier withdrawals may incur an IRS penalty.

**3. Make the maximum allowable salary contribution to your company's 401 (k) plan.** If your company makes matching contributions, the return on your investment is immediate. Furthermore, the tax on your 401 (k) plan is deferred. *Extra benefit:* many 401(k) plans offer borrowing privileges to participants.

**4. Don't be trapped by the Alternative Minimum Tax.** If you have large itemized deductions or donate large charitable gifts of appreciated property, you may be subject to the alternative minimum tax. If you are an AMT target, your tax plans may need to be drastically changed.

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- **Abandon property.** Write off business depreciable property that has lost all of its value. Your business can take a full deduction for the remaining undepreciated basis in the property by abandoning it. To claim the deduction you must dispose of the property.
- **The pass through income of an S corporation is not subject** to employment or self employment tax. Owners who are employees of their S corporations only pay employment taxes on

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## TAX POINTS

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their wages. **Loophole:** The smaller the owner-employee wages the less employment taxes that are paid.

- **Second marriage tax loophole:** The filing of a joint tax return when one spouse owes back taxes can put the other spouse's tax refund at risk. The IRS will keep the refund if back taxes are owed by one spouse, but if you file married filing separately, the spouse who owes no back taxes and is due a refund will receive the refund.
- **The Pension Protection Act of 2006 contains valuable retirement plan breaks** for your business. Example: Roth 401(k) plans are now available. Most businesses did not adopt them because of their temporary status. However, the Act made the change permanent. Add this change to your 401(k) plans.
- **Sell your real estate and defer paying tax** by making a Section 1031 tax free exchange. When you exchange one property for "like-kind property" the taxes are deferred until the second property is sold. To qualify for the exchange or swap the property must be similar.



## Personal Money Management: Ten Major Mistakes To Avoid

1. **Paying more taxes than you have to.** Keep good records so you get all the deductions you're entitled to. Shift income to a year when you'll be in a lower tax bracket. Shift deductions to a year when you'll be in a higher tax bracket.
2. **Not preparing for the unexpected.** Set aside at least two months' income to protect yourself and your family from serious cash flow problems in the event of an emergency.
3. **Not putting your money to work.** Take all excess funds out of no-interest or low interest checking and savings accounts. Put the money to work in liquid but higher yielding places such as mutual funds.
4. **Not setting financial goals.** If you don't have goals, you can't make a plan to achieve them. Write down where you want to be and when. Then start making a plan.
5. **Making investments based on tips.** No matter how well-intended, a tip is the worst reason to make an investment. Investment decisions made under pressure are also unwise.
6. **Failing to have your will updated.** Your situation changes along with that of your heirs. Your will should always reflect your present circumstances.
7. **Not establishing credit in the name of each spouse.** No one likes to think about death or divorce, but not having credit can be much more than a minor inconvenience.
8. **Borrowing money when it's not necessary.** Not all interest is fully deductible. Interest deductions have been sharply curtailed. Don't assume tax benefits when you consider borrowing.
9. **Not keeping organized financial records.** Poor recordkeeping can cost you significant tax savings, cause you to make bad financial decisions, and leave your family with unnecessary problems if you become ill or die.
10. **Failing to put a yearly tax plan to work as early as possible.** Year-end tax planning can be costly. The sooner you put your tax plan to work, the greater your savings.

## MANAGING TIME

- For a more efficient work schedule, keep track of projects by the week, not just by the day. Daily schedules are best for specific tasks that need immediate attention. Weekly plans help to spread your workload. Best time to set up your weekly plan: Monday morning. Best time to establish the next day's schedule: just before you leave work for home.
- The best calendar is one calendar for all your appointments. Avoid the temptation to keep several calendars in various places. If you use more than one calendar, the chances are that you'll forget to transfer information from one to the other. Most executives prefer hand held electronic calendars that are capable of holding more than just appointments and are small enough to be carried with them.

## TAX PLANNING

# 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, 2006. 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

\$35,000 in taxable income. Based on 2006 corporate income tax rates, the company paid federal income taxes of \$5,250 and had more than enough cash to continue its well-tuned operations.

After the 2006 results were in, Fred realized that the business had accumulated surplus cash beyond its foreseeable needs. So in 2007, he increased his salary by \$35,000 - the taxable income that the company earned in 2006. Naturally, when Fred files his 2007 individual income tax return, Fred will pay income taxes on his \$35,000 salary increase. That means the \$35,000 will be taxed twice - first as 2006 corporate earnings and again as part of Fred's 2007 personal income.

That's called Double Taxation, an unwelcome 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 \$125,000 in 2006 instead of 2007. He would then report his salary increase on his 2006 individual income tax return, but the corporation would pay zero taxes for 2006 because Fred's salary increase would be deducted from the company's earnings. That's a corporate tax savings of \$5,250.

The \$35,000 would then be taxed only once and Fred would have brought Double Taxation to a screeching halt.

