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CLIENT'S TAX & FINANCIAL UPDATE

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Tax Points

HOW TO INCREASE PROFITS BY CUTTING PRICES

Although lowering your prices usually means that you'll sacrifice profits, selective price cuts can attract business you might not get at your regular prices. That business is incremental and can mean increased profits.

The key to profitable price cutting is to offer lower prices only to those customers who won't buy at regular prices or to those customers whose volume makes them major contributors to your profits. Selective price cutting for these two kinds of customers requires some thought and planning, but the payoff can be big.

Strategy #1: Identify price-sensitive customers and reduce prices for them

Cutting prices for first-time buyers often creates enough new sales to justify the lower prices. For example, many concert promoters realize that young people can't afford to pay the regular ticket price. Instead of lowering ticket prices to everyone, they offer discount prices to students.

While it's easy to selectively identify students because they carry ID cards, it's more difficult for other types of businesses to iden-

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- **Life insurance is included in your estate** for estate tax purposes. If this causes additional taxes to be paid on your estate, your beneficiaries will inherit less. **Loophole:** To get life insurance out of your estate, set up an irrevocable life insurance trust to own the policy. Upon your death, the life insurance proceeds will not be included in your estate for estate tax purposes.
- **Benefitting from accountant-client privilege.** Accountant-client privilege cannot be used when

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TAX POINTS

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dealing with the IRS. **Loophole:** If you have litigation with the IRS, have your lawyer hire your accountant to have your accountant's work protected by attorney-client privilege.

- **Overlooked medical deductions.** Medical expenses that exceed 7.5% of your adjusted gross income are deductible. Commonly overlooked expenses are: (1) travel undertaken for medical reasons, and (2) home improvements and additions to the extent that the cost exceeds any increase in the value of the affected property.
- **Money saver: Restructure debt.** Low interest rates are an incentive to refinance old debt as well as providing tax benefits. Interest on consumer debt cannot be deducted, but mortgage interest (within limits), business interest, and investment interest up to investment income is deductible. **Strategy:** Refinance high interest non-deductible consumer debt with low interest fully deductible debt.



TAX TIP

Don't give your home to your child.

If you give your home to your child while you're still living, the IRS will consider the child to have received it on a "carryover basis", which is your original cost plus certain adjustments. When the house is later sold, the child will be taxed on the difference between the adjusted carryover basis and the sale price.

On the other hand, if you *will* your home to your child, the tax consequences will be more favorable. You and your spouse can will up to \$2,000,000 in assets free of estate taxes, and if your child sells the inherited house, the taxable gain will be based on the difference between a stepped-up basis and the sale price - usually a substantial savings.



THE TEN BIGGEST FINANCIAL MISTAKES PEOPLE MAKE

Most financial planners agree about the ten most common financial planning errors people make. Here's the list.

1. Failing to plan retirement financing.
2. Failing to carry an "umbrella" policy to protect against risks not covered in other policies.
3. Investing too much in one stock, usually the employer's stock.
4. No disability insurance or too little disability insurance.
5. Holding investments which are not productive.
6. No will or an outdated will.
7. Failing to use a short term trust to save taxes.
8. Investing in unwise or unnecessary tax shelters.
9. Relying on variable income to meet fixed expenses.
10. Failing to coordinate estate planning with personal financial planning.

TAX PLANNING

LOWER YOUR SALARY AND MAKE MORE MONEY

If your incorporated business pays you rent for real estate that you own personally, the tax laws can have a significant impact on your personal income tax planning.

Tom Hunter is a good example. Tom owns Hunter Luxury Cars, Inc., a very successful automobile dealership that Tom built from the ground up. Luxury cars had been a way of life for Tom since the day his father showed up in a gleaming new '68 Cadillac. Tom cared for that car as if it were a member of the family and the high point of each Saturday was the half-hour neighborhood drive that was Tom's reward for washing and buffing that treasured automobile.

Years later, Tom founded Hunter Luxury Cars. Thanks to Tom's driving ambition, the business got off to a fast start. One after another, Tom delivered Mercedes, Jaguars, and BMWs to satisfied customers. As he steered the business toward even greater success, Tom bought some land, built a new showroom, and rented the property to his now incorporated business.

Like many taxpayers in his situation, Tom reasoned that if the business paid him a low enough rent, he could show a loss on his rental property, deduct the loss on his personal income tax return, and lower his income taxes accordingly.

By 2006, Hunter Luxury Cars, Inc. was humming along like a well-tuned engine and was paying Tom a salary of \$170,000 a year. Because of the low rent he receives from the corporation, Tom

will show a \$40,000 loss on his property and he plans to write it off on his 2006 personal income tax return.

But Tom's tax plan suddenly ran out of gas when he filed his federal income tax return. Based on his \$170,000 salary, the \$40,000 net loss on his rental property, 2006 joint return rates, personal exemptions of \$6,600, and ignoring all other deductions, Tom's federal income taxes totaled \$32,272, far more than he had expected.

A BETTER SOLUTION

Tom's tax plans came to a screeching halt when he discovered that he could not deduct his \$40,000 rental loss. Under the tax laws, rental losses from property in which the taxpayer is an active management participant are considered **passive losses**. Passive losses can be deducted only to the extent that they offset passive income. In addition, **passive losses** cannot be deducted from **active** income, such as wages.

However, a special exception applies to passive losses from rental property. This exception permits a deduction of up to \$25,000 in rental losses in excess of passive income for taxpayers whose adjusted gross income is \$100,000 or less. The \$25,000 is phased out for taxpayers whose adjusted gross income exceeds \$100,000. If, as in Tom Hunter's case, a taxpayer's adjusted gross income is more than \$150,000, **no deduction is allowed**.

Although passive losses which are not deductible in a current year may be carried forward to future years, the tax bite that Tom Hunter faces for 2006 could have been greatly reduced.

If Hunter Luxury Cars, Inc. would pay Tom a salary of \$130,000 instead of \$170,000, he could receive the \$40,000 difference in the form of additional rent. His total income will still be \$170,000, but his federal income taxes will then be \$21,390 instead of \$32,272.

It doesn't pay to spin your wheels in the tax law quagmire. See your accountant for a professional tax planning tune-up.

