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

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The Biggest Blunders You Can Make Starting A New Business

Recent surveys show that new businesses consistently make the same mistakes. Here are the most common.

- **Underestimating the need for capital.** The majority of new businesses are undercapitalized and are not prepared to find sources for additional capital when it's needed. Undercapitalization is the single biggest cause of problems for a new business.
- **Overestimating sales projections.** New entrepreneurs are invariably overly optimistic about potential sales, particularly for the first year of doing business. When sales reality sets in, it's often difficult to take corrective action.
- **Unexpected cash shortages.** New businesses frequently do not understand the importance of cash flow. They fail to realize that cash flow is the source of most business growth. By underestimating how much cash is needed to operate, and overestimating how quickly customers will pay, new businesses can find themselves in an unexpected cash flow trap.
- **Incorrect pricing.** Underpricing is always the result of underestimating the costs of product development, production, and overhead. Many new entrepreneurs fail to do their homework by not determining what prices the market will accept.

- **Poor business plans.** A good business plan is not only a necessity for

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taxPOINTS

Loophole. Plan your asset allocation to maximize tax benefits. Invest your tax-deferred accounts, such as a 401(k) and a regular IRA, in higher-yielding fixed-income securities, and invest non-tax-deferred accounts in lower-yielding but capital gains producing assets. **Reason:** Realized long-term capital gains and dividends are taxed at favorable tax rates – a maximum of 15% federal tax when held in taxable accounts. Unrealized capital gains are not taxed at all until the asset is sold. **Contrast:** Capital gains in a tax-deferred account will be taxed at much higher ordinary income tax rates when distributed from those accounts.

Loophole. Beneficiaries who sell inherited property at a loss can deduct the loss on their tax returns. Example: Your parents leave you a house with an original purchase price of $50,000 that is worth $300,000 when both parents have died. You inherit the house free of estate tax and receive a "stepped-up" basis (tax cost) of $300,000. The house is sold for $270,000 after brokers' commissions and selling costs. You can deduct $30,000, subject to annual loss deduction limits, as long as you didn't use it as your personal residence and immediately offered it for sale or rental. **Note:** Capital losses are deductible dollar for dollar against capital gains and can offset up to $3,000 of ordinary income each year. Excess losses are carried forward to subsequent tax years.

Better Ways to Manage Accounts Payable

In addition to paying your company's bills on time to establish good credit, you should manage accounts payable to improve profitability. You can do this by taking advantage of discounts for early payment, cashing in on the time value of money, and seeking out credit options.

Here are a few ways you can manage accounts payable to make your company's money work better.

- Don't pay all your bills at the same time. Although this is common practice in many businesses, it can cause a sudden drain on your cash flow and leave you short of needed operating funds.
- Although vendor discounts for early payment are often attractive, the savings from these discounts may not offset the benefits of keeping cash on hand for a few additional weeks. For example, you may be able to use that money in other ways to earn more than an early payment discount.
- Negotiate extended terms of payment with certain vendors to improve your cash flow. Vendors to whom your business is important will usually cooperate.
- Ask vendors to submit invoices on a date when you know your cash flow will be healthy. Many companies collect most of their receivables at a particular time of the month. Vendor invoicing at that time can help you control your cash flow better.

Deducting Your Spouse's Travel Costs

If there is a legitimate business reason why you take your spouse with you on a business trip, you can deduct his or her travel costs. In addition, some of your spouse's travel costs may be deductible even if there is no business reason for the spouse's travel. Some examples:

- **Hotels.** If the rate for a single room is $140 and the rate for a double room is $180, you can deduct $140 of the $180 of the double room rate.
- **Entertainment.** If you and your spouse entertain a customer, 50% of the cost is deductible.
- **Travel.** If the cost of your single regular fare is $600 and you are able to purchase special tickets for $400 each for a couple, you can deduct the regular $600 fare if you take your spouse.
- **Meals.** As is true of all business meals, 50% of the cost is deductible if your spouse and you have a meeting with a customer and business is discussed.

Self-Employed? Here's How A Retirement Plan Can Reduce Your Taxes

If you are a self-employed individual with earnings from your business activities, a Keogh plan is one of the most attractive tax shelters available.

Take Jim Butler, for example. Jim owns The Body Shop, a successful physical fitness center. Fitness had always been a way of life for Jim. As a high school student, he was a star athlete in all major sports, and in college he discovered his ability as a long distance runner.

So, when Jim opened The Body Shop in 2003, it came as no surprise that he had decided to "go for the gold". Thanks to Jim's dedication to hard work, The Body Shop got off to a fast start and by 2011, its membership list had swelled as local businessmen pedaled away excess pounds and exercised their way to better health.

Under Jim's expert guidance, The Body Shop is in just as good shape as its customers. In 2011, the business set another record for Jim and had a year-end profit of $230,000. But all that glitters is not gold, and when Jim and his wife filed their individual federal tax return, Jim discovered that the IRS wants to share in his profits. Based on 2011 joint return tax rates, exemptions for himself and his wife, Jim Butler's federal income taxes totaled $44,433.

A BETTER SOLUTION

Jim was a front-runner in business, but his track record in tax planning left something to be desired because he didn't know about the advantages of a keogh retirement plan. For taxpayers like Jim who have earnings from self-employment, a keogh plan reduces current and future income taxes while it simultaneously allows the taxpayer to fund a retirement plan.

Current income taxes are reduced because contributions to a keogh plan are allowable deductions up to a specified limit. Federal and state income taxes for future years are also reduced, because the earnings from funds in a keogh account are not taxable until they are removed from the plan and distributed to the taxpayer, usually after age 59 ½.

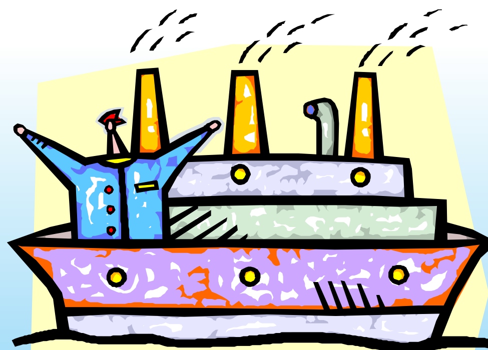
There are two basic types of keogh plans: defined contribution plans and defined benefit plans. There are several variations on each of these plans, but for reasons of simplicity, we'll describe only one – the defined contribution "money purchase" plan – because it's a clear example of the benefits of a keogh plan.

Under a money purchase pension plan, the maximum annual keogh contribution for 2012 is 25% of earned income not to exceed $50,000. Numerous other rules apply, but here's how a defined contribution money purchase keogh plan would have created sizable tax savings for Jim Butler in 2011 and well into the future.

Based on The Body Shop's 2011 earnings of $230,000, Jim would have been allowed to contribute $44,060 to a keogh plan, the maximum contribution for 2011. For tax purposes, the entire $44,060 would have been a deduction on his 2011 individual income tax return and his federal income taxes would have been reduced from $44,433 to $32,096.

That's a tax savings of $12,337, a big step toward Jim's long distance goal of a comfortable retirement.

Tax deductible retirement plans are also available to corporations, but for self-employed front-runners like Jim Butler, a keogh plan is tough to beat.



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The Biggest Blunders You Can Make Starting A New Business

raising capital, it's also a detailed road map for running a successful business. A sound business plan includes a timetable for achieving specific business objectives, a complete review of the competitive situation, and a description of the business's operating and administrative systems.

- **Premature product introduction.** Too many new products are rushed to market before they have been tested, often with disastrous results. It's almost impossible to recover from the damage a defective or poorly designed product can cause. In addition, many would-be entrepreneurs fail to do any market testing. The positive opinions of friends and relatives are a poor substitute for researching the real marketplace.
- **Failure to seek professional advice.** Almost every prospective entrepreneur needs objective professional advice about some aspect of starting and operating a new business. It's rare that *any* individual can develop a sound business plan, project financial needs, and formulate an effective marketing program. The successful entrepreneur realizes this and seeks the advice and assistance of objective experts.
- **Ego and failure to delegate authority.** These two problems go hand-in-hand. The natural enthusiasm of the budding entrepreneur can have a very positive effect on a new business. However, a strong ego is often the cause of failure to delegate, because the entrepreneur thinks no one can perform any task, no matter how trivial, as well as he can. This can delay or even prevent growth, because no entrepreneur can handle everything without help.
- **Lack of effective employee incentives.** Too many entrepreneurs don't establish strong and attainable employee incentives. In start-up situations, employee salaries are usually not high. So unless bonuses, profit sharing, or other realistic incentives are offered, the new business won't be able to attract – or keep – the best employees when it needs them the most.

Tax Tips

Interest paid by a shareholder on a corporate loan is not deductible

As a shareholder in a closely held corporation, you might be required to personally guarantee a loan made to the corporation. When the interest is due, the corporation may not be able to pay for it, and you might make the payment with your personal funds.

In such a case, you cannot take an interest deduction for this payment on your personal income tax return. The IRS holds that payment of a corporate expense by a shareholder is not deductible by the shareholder because the primary obligation is that of the corporation while the shareholder has only secondary liability for the loan.

Keep a record of the source of your bank deposits

Make it standard practice to keep records of the source of all your bank deposits. If you are audited by the IRS, these records could protect you from paying taxes and penalties that you don't really owe.

If the IRS suspects that you haven't reported all your income, it can ask to see your bank statements. If you have made a deposit that isn't taxable (such as the proceeds from a loan) you may have to pay taxes and penalties on it if you can't provide the source of the deposit.

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