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CLIENT'S tax & financial UPDATE

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

How Much Life Insurance Do You Really Need?

Having adequate life insurance is particularly important if you have dependents and your estate is modest. But buying too much insurance is a needless expense. There are two steps you should take to assure adequate protection at the lowest possible cost.

First, you must determine the amount of insurance that will satisfy your specific needs. Second, you must choose the type of insurance that's best for your situation.

How to determine the amount you need

The traditional rule-of-thumb was that you should purchase coverage equal to five times your salary, but today's financial advisors recommend a simple four-step method to pinpoint exactly how much life insurance you need.

1. **Determine your family's living expenses.** Be sure to include food, clothing, housing, utilities, transportation, insurance, education, medical care, and taxes.
2. **Calculate the portion of your family's expenses that are attributable to you.** As a general rule, it takes about 70% of current income to maintain a family's standard of living if one spouse dies.
3. **Divide the annual income your family will need by 7%.** This will give you the amount of money that would have to be invested at 7% to receive the annual income you determined in step two.
4. **Deduct your income-producing assets from the amount needed.** This will tell you the amount of insurance you need.

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taxPOINTS

Tax Strategies: Buy Municipal Bonds. The purchase of municipal bonds can shelter income from tax. Consider investing in tax-free mutual funds and municipal unit trusts as well as single-issue bonds.

Loophole: Donated property. Property that has appreciated in value and has been owned for more than one year, you receive a deduction for its full market value in the year donated. You do not have to pay a tax on the appreciation. **Example:** Stock that has appreciated in value.

Loophole: Write-off worthless securities. Losses from the worthlessness of stock or other securities are deductible in the year in which the security becomes worthless. They're deductible as capital losses. One way to establish the loss is to sell the security to a friend for a nominal amount – say a dollar.

Loophole: Like-kind exchanges. No gain is recognized on the exchange of business or investment property (i.e., land, building or equipment) if the property received is of a like kind and is used in a business or for investment. The tax is not due until that time you sell the property received in the exchange.

Your IRA Account Is Still A Smart Investment

Since the Roth IRA, many people think that regular Individual Retirement Accounts are obsolete. But regardless of whether your IRA contribution is deductible, you can still defer taxes on the earnings of your IRA account until you actually withdraw the money. And the longer your money remains in your IRA, the greater the effect of tax-deferred compounding. Here's how a yearly $5,000 IRA investment compounded annually can grow when its earnings are tax deferred.

	5%	8%
40 years	$634,199	$1,398,905
35 years	$474,182	$930,511
30 years	$348,804	$611,729
25 years	$250,567	$394,772
20 years	$173,596	$247,115
15 years	$113,287	$146,621
10 years	$ 66,034	$ 78,227
5 years	$ 29,010	$ 31,680

Competitive Intelligence: A Checklist For Better Marketing

To develop a truly effective marketing program, you should know as much as possible about your major competitors. The following competitor information should be kept up to date at all times:

- **Management:** who are they, what is their business philosophy, how do they tend to operate.
- **Company size:** revenues, products, share of market.
- **Operating results:** profitability, strategic results.
- **Resources:** financial strength, major investors.
- **Strengths and weaknesses:** marketing, distribution, opportunities and threats.
- **Positioning:** how customers see them.
- **Technological capabilities:** past, present, and probable future.
- **Product and market emphasis:** new product release patterns, preferred target markets.

Why Pass-Through Entities Face Much Lower Audit Risk

Organizing a business as a pass-through entity (S corporation, partnership, or limited liability company taxed as a partnership) rather than a proprietorship can lower its audit risk in two ways.

First, pass-through entities have a much lower audit rate than a proprietorship in general.

In addition, some reporting items that can act as audit red flags on a proprietorship's Schedule C do not exist in a pass-through entity's tax filings.

Example: The home-office deduction is considered by many to be an audit red flag on an individual's tax return. It is claimed by attaching IRS Form 8829 to the Schedule C – thus "announcing" the deduction to the IRS and breaking out its component elements (the size of the office relative to the size of the home, amounts deducted for utilities and maintenance, etc.).

Contrast: If the same business is organized as a single shareholder S corporation, the owner can have the same office and deduct the same costs – but the deduction is not reported directly on his/her personal return, and a Form 8829 is not included.

Instead, because he is an employee of the corporation, he will obtain reimbursement for his office expenses from the corporation. When the documentation requirements of an "accountable plan" are met, the reimbursement is tax free to the owner and deductible by the corporation.

Advantages: The reimbursement cost reduces the corporation's income (or increases its loss) – and, since its income is taxed to the shareholder, this deduction "passes through" to shareholder and effectively provides the deduction on the individual tax return indirectly.

Benefit, no specific "home-office deduction" is reported on the individual income tax return – so the audit red flag does not exist.

Save Taxes By Using The Cash Method Of Accounting

How it works: Under the accrual method, businesses report income when they have a right to receive payment and deduct expenses when they become liable for them. Under the cash method, businesses report income and deduct expenses for monies actually received and paid. Businesses that have money owed to them do not have to pay tax on money they have not yet received.

Generally, companies with inventory must use the accrual basis, unless they meet certain small-business exemptions. A small business (one with less that $1 million in average sales) can use cash basis accounting even if it has inventory.

Note: C corporations with average sales of more than $5 million must use the accrual basis.

Service businesses that have no inventory and are not C corporations can use the cash method. This method is especially helpful to service businesses selling related products, for example, plumbers who also sell plumbing supplies.

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How Much Life Insurance Do You Really Need? (continued)

Example	
Your family's present yearly expenses	$100,000
Your family's yearly expenses if you die ($100,000 x 70%)	70,000
Amount of capital needed to earn $70,000 annually ($70,000 ÷ .07)	$1,000,000
Less income producing assets	200,000
Amount of insurance needed	**$800,000**

When you need temporary insurance

If your life insurance needs are temporary, buy term insurance. Term insurance is cheaper than permanent insurance because it protects you for a limited number of years rather than for your lifetime. It also does not build up a cash value.

Term insurance can be the right choice if you can't yet afford the permanent coverage you need, or if you have short-term debt that you don't want your family to be responsible for.

When you buy term insurance, consider the following features:

Guaranteed renewability. This is a must. Although it increases the premium, it lets you renew your insurance at a guaranteed rate without having to pass a medical examination.

Re-entry privilege gives you the option of taking a medical exam at the time of renewal. If you pass the exam, it can mean a lower premium than your policy's stated guaranteed renewable rate.

Convertibility lets you convert your term insurance to permanent insurance up to a specified age without taking a physical exam.

When you need permanent insurance

There are many types of permanent insurance. The most common types are:

Whole life insurance, which provides a guaranteed death benefit and a cash value with a guaranteed minimum interest rate.

Universal life insurance, which combines insurance coverage with investing. The policy's return fluctuates, depending on the performance of the insurance company account in which you invest. Cash value isn't guaranteed, but can increase if the investment account does well. The death benefit also fluctuates, but usually not below a guaranteed minimum.

Universal variable life insurance combines the premium option of the universal life insurance with the investment features of variable life insurance.

Single premium life insurance provides relatively low death benefits because most of the premium payments go into the investment portion of the policy, which is primarily a tax-sheltered investment vehicle.

Cutting Costs

Finding waste.

You have to know what is waste before you can eliminate it. Most people will get rid of waste when they recognize it, but the first step is to identify it. Once that's done, the problem of waste will usually take care of itself.

Cutbacks can be costly.

Too often, work done by terminated employees is transferred to those who remain after the cutback. The new heavier workload can overburden well-qualified employees so that the company is actually in worse shape than it was before downsizing.

Avoid this costly trap by eliminating work at the same time you cut back your work force. Give special attention to tasks that can't be transferred to employees whose wages are the same or lower than the dismissed employees. Assigning clerical chores to managers not only hurts morale, but actually increases costs.