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CLIENT'S tax & financial UPDATE

VOLUME 35 / NUMBER 2

NOVEMBER - DECEMBER 2012 ISSUE

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

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 identify price-sensitive customers. You can't ask customers if they are price-sensitive because very few would give you an honest answer.

The proper way to do this is to determine the buying habits and product sensitivity to price. Walk into any automobile dealer showroom and you'll see this strategy in action.

Skilled automobile salespeople will quickly engage you in what appears to be a casual conversation. Within minutes they'll find out what you do for a living, where you live, and what kind of

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YEAR END TAX SAVERS

College savings. Some states allow state income tax deductions for contributions to Section 529 college savings plans. If your state does, and you're planning to send a child to college, consider making one.

Individual retirement accounts. Convert a traditional IRA to a Roth IRA to obtain future tax-free investment returns from the Roth IRA while escaping minimum annual distribution requirements. **Added benefit:** You can reconsider and reverse the conversion if you later decide it is not in your best interest or that you can make the conversion at a lower tax cost later if the value of your account had dropped – as late as October 15, 2013. You may reverse a conversion only once in a single year.

Capital losses. Take capital losses to end up with a $3,000 net loss for the year. A loss of up to that amount is deductible against ordinary income.

Combined Payrolls Can Produce Tax Savings

It's not unusual for closely-held corporations to operate through more than one division and for key employees to be on the payroll of both. If an employee's combined salary from each corporation totals more than $110,100 excess Social Security taxes might be incurred.

There's a way, however, to avoid this problem. Instead of each corporation issuing its own payroll check, designate one company in the group as a common paymaster, which can issue one check to the employee on behalf of all the companies involved. To do this, you must meet *one* of these three criteria:

- The corporations involved must have at least 50% common ownership.
- Half or more of the officers of one corporation must also be officers of another.
- The corporations must share at least 30% of their employees.

The result? Let's say an employee is drawing a $100,000 annual salary from each of two corporations. Since the maximum Social Security tax is owed on the first $110,100 paid by each employer, the company will have to pay taxes on $200,000 in total. If a single check from the common paymaster company is issued, $89,900 of the total amount will be exempt from excess Social Security taxes.

Four Ways to Lower Your Borrowing Costs

It's widely acknowledged that bank credit standards vary among banks and that, even with one bank, its credit policy will vary depending upon changing economic conditions. Coupled with the cost of borrowing, tougher credit standards mean you should make every effort to keep your borrowing requirements down. But when you do have to borrow, here are four tips to help you keep the cost of borrowing to a minimum.

1. Negotiate interest rates. Not all banks will immediately quote their lowest rate. If you can't get a somewhat better rate by asking a few questions, it might pay you to shop around – preferably with your bank's biggest competitor.

2. Don't borrow more than you need. In most cases, the best strategy is to establish a line of credit for a given period of time. However, be sure to keep a close watch on the fee the lender charges for the unused portion of your line of credit. The typical charge often varies among banks.

3. If you have a solid relationship with a loan officer, stay with that bank. This is particularly important as credit standards become tighter. When a loan officer sees that your financial management history has been good over a period of time, your credit standing is greatly enhanced.

4. When your cash flow is good, consider prepaying a loan. This simple strategy can improve your credit standing, save you money, and enhance the lender's opinion of your ability to manage money.

Lower Education Expenses by Making Them Deductible

One of the biggest expenses most people will face during their lifetime is the cost of education, both for their children and for themselves. However, with a little creative planning, you can lower those education expenses with some help from the IRS.

Your children's education

Buy a second home for your child to live in at college. Instead of paying housing expenses to a college or paying rent to a landlord, your child can live in your second home. If it is your only second residence, you can take several deductions.

- You can deduct the interest on the mortgage for your second home as long as the total of the mortgages on your primary residence and your second residence is not more than $1,000,000. You must use the mortgage proceeds to buy, build, or improve the home.
- You can deduct the interest on a home equity loan as long as the total of the home equity loans on both of your residences do not exceed $100,000. And the home equity loan cannot exceed the home's fair market value less the mortgage which was used to buy or improve the home.

Buy rental property for your child to live in at college

If your child pays you a fair market rent and you actively manage the property yourself, you can deduct your property taxes, maintenance, repairs, depreciation, utilities, and other expenses from your rental income. The maximum rental losses you may deduct is $25,000 if your Adjusted Gross Income does not exceed $100,000. If your Adjusted Gross Income is between $100,001 and $150,000, the $25,000 maximum deduction is phased out.

Your own continuing education

You can deduct the cost of non-reimbursed tuition, books, and supplies if your employer requires you to take courses as a condition of your employment, or if you take courses to maintain or improve your job skills. If you travel directly from work to school, you can also deduct transportation costs, including tolls and parking.

However, education expenses must be included as miscellaneous itemized expenses on your personal income tax return and you can only deduct your total miscellaneous itemized expenses to the extent that they exceed 2% of your Adjusted Gross Income.

Student loans

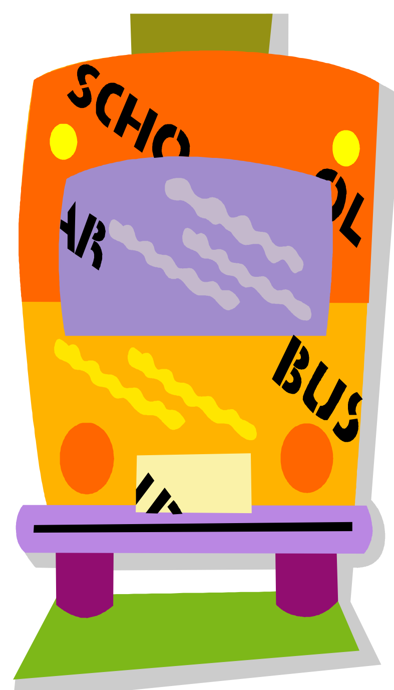
The maximum deductible amount of interest on education loans is $2,500. Deductibility is based on income. If your interest is greater than $2,500 or is limited, it may be better to take out a home equity loan because the interest is fully deductible. By using the proceeds from a home equity loan, you effectively convert your interest on education loans to fully deductible interest.

American opportunity tax credit

For 2012, an enhanced version of the Hope scholarship tax credit, called the American opportunity tax credit, is available to taxpayers who paid tuition and other expenses for an eligible student during 2012. The amount of the credit is 100% of the tuition and related expenses paid by the taxpayer during the tax year for education furnished to the eligible student during any academic period beginning in the tax year up to $2,000, and 25% of the next $2,000 of the same expenses, for a maximum credit of $2,500.

Tuition, required enrollment fees, books and other required course materials generally qualify, and eligible students must be enrolled at least half-time.

The American opportunity tax credit is allowed for four tax years per student, and for the first four years of post-secondary education at an eligible educational institution. Even taxpayers who owe no tax can get a payment of the credit of up to $1,000 for each eligible student.



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car you presently own. From what you tell them, they'll have a very good idea about what kind of deal to offer: a low price on a "stripped" car, a high trade-in allowance on your old car, a lease instead of a purchase, or perhaps an extended warranty.

The best time to make plans for price-sensitive customers is when you are developing a new product or service. Include certain features in your new product that are very important to your least price-sensitive customers who won't buy at your regular prices.

Strategy #2: Reduce prices on items that are important to your biggest customers

The most obvious use of this strategy can be seen in supermarkets, whose profits depend on their ability to attract shoppers with large families. Instead of pricing all items for a similar profit, supermarkets will offer sharply reduced prices on items which are important to large-family shoppers - sandwich bread, eggs, peanut butter, and beverages. Supermarket operators know that while large-family shoppers are in the store, they'll also buy items which have better profit margins.

Strategy #3: Beat "favored customer" agreements

In industrial markets, pricing is so critical that many companies demand that their suppliers sign a "most favored customer" contract. These contracts are an agreement by the supplier to give the customer the lower price for a specific product. Vendors often have no choice but to sign these contracts if they want to sell to large companies.

You can avoid the constraints of a most favored customer contract by making some minor changes in a product and selling it to others at a lower price and by marketing a version of the product that "more favored customer" won't want.

The critical element in profitable price-cutting is selectivity. Across-the-board price cuts are rarely the answer to improve profits.

Better Thinking

Let your customers tell you what quality is.

Make sure that efforts to improve quality are driven by customer needs. You don't improve quality unless you improve a product in a way that customers welcome and appreciate. Before you undertake a quality improvement effort, always ask yourself whether your customers will see it as a benefit to them.

Improve collections with a well-designed invoice.

A few key tips: Keep the invoice clean and simple and test it on someone who's not familiar with the business. Make sure the form is titled with the word "invoice." Use a special typeface for critical information such as the outstanding balance and the item purchased. Use action words such as "please pay" instead of "amount due." The invoice should have an area where the customer's purchase order number can be indicated. Including a self-addressed return envelope will often speed up payment.

Tax Tip

Inherited Property

If you sell inherited property at a loss, you can deduct the loss on your tax return.

Example: Your parents leave you a house with an original purchase price of $100,000, and a market value of $300,000. You inherit the house estate tax free, receive a "stepped-up" basis of $300,000, and hold it as an investment (you do not live in it). When you sell the house for, say, $260,000, you can deduct $40,000, subject to annual loss deduction limits. (As mentioned earlier 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.)

Added benefit: The loss is deductible even if it is created by brokerage commission payments.