

Substitution, Switching and Switching Costs

Businesses come and go. Products come and go. What is the future of your business? Your industry? The answer often lies in issues related to substitution, switching and switching costs. As a business owner, your future may hinge on your understanding of these concepts.

Substitution: An Alternative Method or Solution

Substitution is the process by which one product or service supplants another in performing a particular function or functions for the buyer. For example, a customer chooses to buy a color printer and print their own fliers rather than have a commercial printer print them. Or, a teacher chooses to buy school supplies from an Internet-based supplier rather than by driving to their local school supply retail store. Or a new building chooses an electronic sign rather than a traditional wood moniker.

Will it be your product that is being replaced by an alternative offering provided by someone else? Or will the product sold by another be dropped in favor of your product or service?

If you are a manufacturer of two-way radios (commonly referred to as walkie talkies), the advancement of low cost, feature rich cellular phones has introduced a powerful threat of substitution. Users of walkie talkies, such as construction companies, can have their need for quick, two-way communication "in the field" met with some types of new cell phones, such as Nextel's phone that has a two-way radio function. The traditional radios might get the job done, but the new cell phones offer the same function plus many more features. Absent a dramatic strategy for countering this threat with an offer that equals or betters the price-to-value offer of the cell phone, the walkie talkie business may quickly become extinct.

Identifying Substitutes: Threats and Opportunities

As a business owner, you need to be on the look out for substitutes that could arise and threaten your market and your ability to control your pricing. Doing so requires that you search for products or services that perform the same generic function or functions as your own. For an obvious

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From The Editor

Fall colors signal that it is time for the year-end push. You set goals for 2003. Some you vaguely remember. So it is time to re-visit the things that you eyed accomplishing as the year began. Even if you have not looked at those notes since you made them, you likely have made progress. Simply the act of writing them down etched them into your psyche and got you working towards them.

As we hit Thanksgiving and the holiday get-togethers, there will be many distractions. Will they be just that – distractions to an unfulfilling, underwhelming year? Or will they be a reward for accomplishment and work well-done? The next four to six weeks may determine which it will be.

So go ahead and re-visit your 2003 goals. This year's game is not over yet. It is simply time to make a quick plan for 'putting some points on the board'. Gather your troops, set a strategy and get them on the field. A few more weeks of hustle can make the holidays a joyous time to celebrate business-related accomplishments ... in addition to personal, social, familial and spiritual celebrations.



David L. Perkins, Jr.

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Publisher and Editor

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LAW

Bankruptcy Law: Created to Benefit Us All

United States law allows individuals and/or legal entities including businesses to trade, borrow and lend as they see fit. This right is fundamental to our free market, capitalist system. It gives those that sell goods and services the freedom to offer “terms” at their own risk. It gives lenders the right to lend at their own risk. Moreover, it allows businesses and individuals to borrow and make promises to pay at their own risk.

Our system works very well. However, it has weaknesses, of course. One example is when a debtor becomes unable to repay either temporarily or permanently. What if the debtor is a business that has promise and employs many, but if forced to pay as originally agreed would have to close? Should the creditors hold the fate of the employees in their hands entirely? Or, what if the debtor is an individual that could never earn enough to repay? Should the individual face a lifetime of insolvency - in effect forever losing their freedom to peacefully exist and have normal debtor-creditor relationships?

U.S. bankruptcy law was created by Congress under its Constitutional authority to “establish ... uniform laws on the subject of bankruptcy throughout the United States.” The purpose was to protect the debtors, creditors and related parties (such as employees) in these extreme cases. Bankruptcy proceedings are supervised by and litigated in the United States bankruptcy courts. These courts are a part of the district courts of the United States.

There are two basic types of bankruptcy proceedings. A filing under Chapter 7 is called liquidation. It is the most common type of bankruptcy proceeding. Liquidation involves the appointment of a trustee who collects the property of the debtor, sells it and distributes the proceeds to the creditors. Bankruptcy proceedings under Chapters 11, 12 and 13 involves the rehabilitation of the debtor to allow him or her to attempt to “get back on his or her feet,” in order to use future earnings to pay off creditors.

In almost all cases, a trustee is appointed to supervise the assets of the debtor. A bankruptcy proceeding can either be entered into voluntarily by a debtor or forced by creditors. And, various provisions of bankruptcy law establish the priority of creditors' interests (i.e. how it is determined who get what and when).

After a bankruptcy proceeding is filed, creditors (for the most part) may not seek to collect payment or seize assets of the debtor outside of the proceedings (i.e. without the approval of the bankruptcy court). And, the debtor must obtain court approval before transferring property that has been declared part of the estate subject to the proceedings. Furthermore, transactions that occur –(such as transfers of property, secured interests and liens) before a bankruptcy filing may be subject to reversal or invalidation to protect the creditors.

For more information visit www.law.cornell.edu/topics/bankruptcy.html or contact your legal advisor. □

“There are two kinds of people in this world. Those that walk into a room and say ‘Here I am!’ and those that walk in and say, ‘Ah, there you are!’”

Harvey Mackay

Computer Security for the Business Owner: Just Three Easy Layers

How do you protect your organization like “the big guys” without a big guy budget? Just like your mother taught you to layer your clothing to keep the cold out and the heat in, layer the protection of your computer systems to keep the hackers and viruses out and the computers running smoothly. It’s as easy as putting on your shirt, sweater and coat.

The Outer Layer – Your Firewall

The broadband explosion has provided Internet users with a better, faster solution for office connection than ever before. The only problem is, the connection is always “on.” Hackers like “always-on” connections such as DSL, cable modems and T1 lines for the same reasons you do – because they are convenient and offer easy access. To prevent unwanted access, you need to place a “firewall” between your cable modem or router and the rest of your network.

Firewalls defend against hacker and virus attacks by implementing a series of rules that permit, or deny, traffic to pass between your computer and the Internet. Based upon the way these rules are set, the inbound and outbound flow of information may be tightened or relaxed. The trick is to maintain a balance between your company’s need for security and your employees’ need to get work done without interference.

The firewall for your organization can be a hardware device or software that resides on a PC (with two Ethernet cards – one connected to the router and the other connected to your network). Two hardware applications designed for small and medium sized business are:

- SonicWall (www.sonicwall.com/products/tele3sp.html), and
- Checkpoint (www.checkpoint.com/products/choice/platforms/sbox.html)

Software-based firewalls can be obtained from:

- Symantec’s Norton Personal Firewall (www.symantecstore.com),
- Broderbund’s ZoneAlarm (www.broderbund.com), and
- McAfee’s Personal Firewall Plus (us.mcafee.com)

The Middle-Layer — Anti Virus Protection

The second layer of protection is your anti-virus program, which is great for finding and deleting virus infected files and Trojan horses that hackers implant on your computer in an attempt to take over your systems. Just in case a hacker or virus *does* pass through your firewall, there is more than a 90 percent chance that the anti-virus software will quarantine the virus or Trojan horse *before* it is allowed to damage your computer.

In lieu of installing and managing anti-virus software on each computer, Symantec’s AntiVirus Corporate Edition provides centralized policy management so that the administrator can create,

deploy and lock down security policies and settings for groups of computers or servers to keep systems up-to-date and properly configured at all times. Centralized management also allows the administrator to audit the network and identify which nodes are unprotected.

The Inside Layer — Solid Backup Policies

The third layer of protection for your business is in making sure that you have a solid data backup plan — just in case an attack gets through the other layers. The most important thing you need to know about your data backups is that you have to keep offsite at least one current copy of all your computer data, and one copy onsite for immediate restoration purposes.

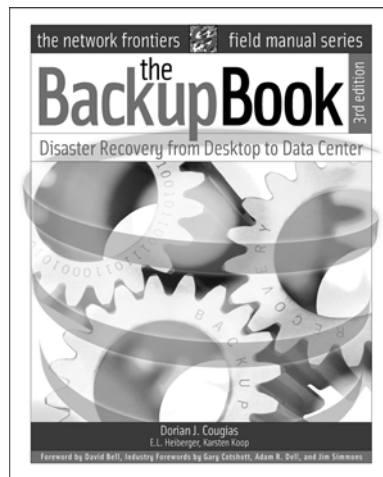
For organizations with less than 200 gigabytes of daily backup needs, there are two good options – disk backup or Internet backup. Disc backup has become as inexpensive as backing up to tape, and it makes the process much easier. This entails the purchase of a hard drive back up system, like those produced by Kanguru (www.kanguru.com), which has from two to eight removable hard drives. Once installed, you can back up to two of your databank’s removable drives using backup software like NovaStor’s Nova Backup (www.novastor.com) for PC networks, or Dantz Development’s Retrospect (www.dantz.com) for mixed PC and Mac networks. Then, you can take one of the two removable drives home with you each night and leave the other backup copy at the office during the day.

Even more effective at getting your data offsite immediately is backing up to the Internet. SkyDesk’s@Backup (www.backup.com) installs software on each computer in order to back it up directly to the Internet. This software is so simple that an option to back up the file or directory is placed within the right-mouse-click operation. Mac users have the same ease of use when backing up to BackJack’s (www.backjack.com) Internet backup service.

Using the Layers to Your Benefit

Whichever backup method you choose, you will want to ensure that you’re backing up all of your important data *daily* ... just in case you *are* hit by a virus or hacker attack. If you do, follow these steps:

- 1) **STOP** your backup process immediately if it is running. The last thing you want to do is back up files that are infected by a virus or Trojan horse.
- 2) **LOOK** at the firewall logs to see where suspicious activity might have come from. Most firewalls now have the ability to identify a suspicious incident and send an e-mail to your Internet service provider or the authorities, alerting them to what has happened and requesting assistance.



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Leaving Specific Property to Someone

Business owners often wish to know how to "bequeath" certain assets to specific individuals or organizations upon their death. The first step, of course, is to create a will. Every business owner should have one. To do so, contact your trusted attorney or other advisor for a recommendation of an estate-planning attorney, and educate yourself with general information found at Internet sites such as www.massmutual.com.

However, what if your wishes change? How do you put the changes into effect? The answer is not as simple as you would think. Here is what to do.

Option 1 for Changing Your Bequests: The safest and clearest way to change bequest instructions is to either create an entirely new will or amend your existing will with what is referred to as a 'codicil.' A codicil must conform to certain laws with respect to design and execution, just as the will must. Therefore, you will want your attorney to assist you.

Option 2 for Changing Your Bequests: If the items at issue are tangible personal property, such as furniture or jewelry, a simpler, quicker and less expensive alternative to Option 1 is simply putting the new desires in writing yourself ... as clearly as you can. It would be a good idea to have your attorney look at it to make

sure it is unambiguous. Then, put a copy of it with your will; provide a copy to the attorney who created the will; and give one to the executor of your estate.

Know, however, that Option 2 may not conform to the strictest interpretation of the law. In addition, it might not always hold up under legal challenge. Even so, this method is regularly recommended and utilized by estate planning attorneys. This is because it works in most every case. It does because the heart of the law concerning these matters (probate law) rests on one simple question, "What was the intent of the person?" If you use some care in making yours known, you should be okay.

BEQUEST OF ASSETS OF SIGNIFICANT VALUE, SUCH AS A BUSINESS

When the asset at issue is of significant value, such as a business, Option 2 above should not be used. Execute a new will or officially amend your current will via a codicil. Moreover, always use an attorney to do so. □

*The Hall Estill Tax and Estate Planning Group
(www.HallEstill.com) consulted in the preparation of this article.*

RISK MANAGEMENT

Limiting Your Personal Financial Exposure

Business owners take risks.

Almost every business is started with a substantial amount of borrowed money. This money is obtained only by making specific promises to repay; and the money to repay comes from future profits. However, what if things don't work out as planned? Are you willing to personally risk everything for the business? Many would do so for the possibility of getting to a higher place. In addition, many don't have much of a choice but to take such risk.

However, there is nothing wrong with trying to stop short of 'risking it all,' or at least limiting the personal exposure. This is done simply by planning not to offer everything. In other words, hold back some personal assets and/or limit the types of promises you make. You set the limits. Lenders can decide whether they want to lend within the limits you set.

Here are some ways to limit your personal exposure:

- Incorporate your business into a legal form such as a C corporation, S corporation or limited liability company. Most very small businesses are sole proprietorships. However, neither the sole proprietorship nor the partnership offers personal financial or legal protection. Incorporating provides for a legal separation between you and your business, and makes it possible for you to have your business make promises to pay that do not include a personal promise from you.
- Hold investments, even business units, in separate legal entities. Then only pledge the assets of that particular investment or legal entity as collateral for the debts incurred for that investment or entity.
- Avoid agreeing to personal guarantee obligations of the business. Similarly, avoid having your spouse personally guarantee the same.
- Avoid pledging personal assets (such as your home, car or other assets) as collateral for business related obligations.
- Don't pledge or use retirement account funds to fund your business. Monies or investments held in retirement accounts are protected (in most states) from the claims of creditors ... even when you file personal bankruptcy.
- Pay all tax obligations that arise from your business. The power of the federal and state taxing authorities is substantial. Even if you have incorporated your business to protect yourself from personal liability, you and every officer of your business are personally responsible for making sure your company pays its taxes. Pay taxes before anyone else!
- Limit financial risk (high leverage) by limiting the amount borrowed. When able, consider alternatives such as slower growth; focus on higher profits rather than simply higher revenues; or, obtain equity capital instead. □

The ESOP Option. Is It You?

I received a call from Mr. Hilary today. We had first talked on the phone a month or so ago when he asked if I “do ESOPs,” also known as employee stock ownership plans. I confessed that I don’t specialize in ESOPs, but rather in representing business owners in maximizing value and minimizing risk in the sale of their business. He was friendly and we chatted further. He shared a little about his situation, inquired about the market for selling a business, and then I wished him luck as he hung up to pursue “the ESOP option.” I had a hunch that I would hear from him again.

What I learned during our first conversation was that Mr. Hilary is a longtime business owner, is well into retirement age without a succession plan, and he

“The unique and attractive attributes of the ESOP can be compelling. However, we find that the costs associated with the ESOP usually make it feasible only for well-established, stable and profitable businesses with 75 or more employees.”

has 20 employees. He enjoys running his business and is in fine health for his age, which is probably why he has not felt pressure to “get something going.” But, as he said, times are changing.

Mr. Hilary worries about not being as sharp as he used to be, and about the risk of falling behind the competition. He also would like to spend more time with his grandkids and has always wanted a “family ranch.” Maybe the time to “cash out” is now, he said. “With an ESOP I can sell to my employees, who’ve earned it, and avoid paying all that my money to Uncle Sam.”

Why did I expect to hear from him again? Well, the ESOP is a one-of-a-kind method for selling ownership in a private business. It has some unique and attractive attributes, but it also has elements that make it a poor fit for many. As such, any business owner considering the ESOP

option should carefully investigate the facts and then compare its pros and cons to the other ways for liquidating and exiting a business.

In short, Mr. Hilary’s motives were genuine, but his selection of the ESOP was naive. He had not looked into the details. Let’s take a minute to do so.

History of the ESOP

Congress created the Employee Stock Ownership Plan (ESOP) in an effort to preserve the economic stability of communities and encourage a wider distribution of wealth. To do so, Congress created tax incentives to encourage the sale of businesses to their employees. The incentives are provided to both the sellers and buyers involved in the ESOP transaction. Therefore, an ESOP is a means by which a business owner may sell his or her business to employees and receive tax benefits for doing so.

How the ESOP Works

Typically, the business owner forms an ESOP trust, a legal entity created with the help of a lawyer. The newly formed ESOP trust then takes out a loan to purchase the owner’s common stock. In turn, the company contributes a portion of its monthly pretax profit to the ESOP to pay off the borrowed funds and allocates prepaid shares to the employees via employee “accounts.” In this way, the owner’s stock in the company is “purchased” by the ESOP and distributed, over time, to the employees. Alternatively, if the purchasing employees have sufficient funds in their retirement accounts, such as their 401(k) accounts, such funds could be used to purchase the ESOP shares thereby reducing or eliminating the need for the ESOP to borrow.

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Advantages of the ESOP to the Business Owner

- Seller may eliminate his or her capital gains tax if he or she invests the proceeds from the sale of stock into qualifying U.S. securities generally within the first 12 months.
- Company payments to the ESOP to repay principal and interest are tax deductible.
- Employee ownership may improve company performance.
- Seller can remain active in the business and retain operating control even after selling all or most of the company!
- Company may be either a C corporation or S corporation.
- 100 percent ESOP owned corporations may avoid federal income taxes altogether!

Disadvantages of the ESOP to the Business Owner

- Healthy cash flow is required to obtain ESOP financing and repay ESOP debt.
- Annual allocation to single employee limited to \$40,000.
- When electing capital gains tax deferral, family members of the seller and 25 percent stockholders must be excluded from the ESOP.
- ESOP is a defined contribution retirement plan and as such, the ESOP is obligated to buy back the stock of departing employees. If many of the employees are near retirement age, this may create a cash burden on the company/ESOP.
- Generally speaking, the annual contribution to the ESOP may not exceed 25 percent of payroll.
- Banks may require the seller to personally guarantee the ESOP debt, or in some other way provide security until financial leverage is lowered.
- Set-up costs can be substantial.
- Companies with accumulated operating losses likely will not benefit from ESOP tax incentives.
- Administrative costs are incurred for items such as the annual valuation, buy back of stock of departing employees, IRS and Labor Department review and reporting requirements, etc.
- Even though the ESOP trustee votes ESOP shares on most issues, in a merger, sale or liquidation of all the assets, the vote must be passed to the ESOP participants and approved by a majority of all shareholders.

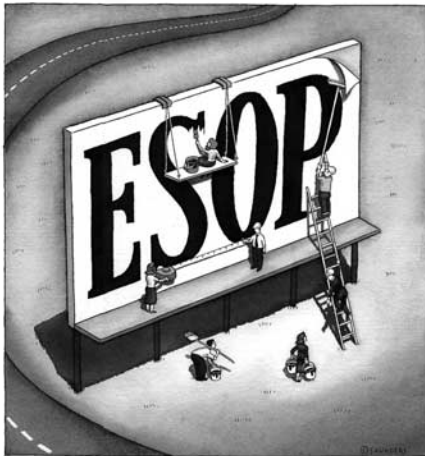
The ESOP Option. Is It You?, continued from page 6

Advantages of the ESOP

The advantages of the ESOP begin with the seller's ability to defer capital gain tax, as long as the proceeds from the sale are invested in domestic corporate securities within the first 12 months. In addition, company payments to the ESOP to repay borrowed funds, both principal and interest, are tax deductible. Moreover, if the company is 100 percent owned by the ESOP and elects to be treated as an S corporation for tax purposes, all of the earnings of the company are exempt from federal income taxes just like a qualified retirement plan. Finally, employee ownership may not only improve company performance, but may allow management and employees to maintain their independence.

Disadvantages of the ESOP

The benefits described above come with strings attached, however. First, ESOPs can be costly. Some practitioners say that set up fees, much like real estate commissions, run between 4% and 7% of the total value of the business, or more. Annual administrative fees for yearly business valuation and required record keeping run in the low five to six figures. Second, most ESOP buyouts



must be funded with debt, which raises the business' financial risk and cash flow burden. So only companies with strong cash flow need apply. Next, if less than 50 percent of the ownership interest were purchased at the outset, a minority discount, often in the 20 percent to 30 percent range, would normally be applied to the control value of the shares. Finally, lenders may require the seller to personally guarantee the ESOP debt and/or pledge the ESOP proceeds until some amount of the borrowing is paid off.

In summary, there is often an immediate appeal to the concept of selling to employees in a way that provides substantial tax savings. However, when we look into the details, we find that the costs associated with the ESOP usually make it feasible only for well-established, stable and profitable businesses with 75 or more employees. And, even if you meet these guidelines, you should identify and rank your priorities and then put them up against what is achievable through the ESOP. If you are looking for a "cash and carry" type of exit, the ESOP likely is not for you. □

James R. Waldo, the director and national head of ESOP corporate finance at Houlihan Lokey Howard & Zukin, contributed his expertise to this article. Mr. Waldo can be reached at 703-714-1732. See also www.esopassociation.org for more information. For alternative exit options to ESOPs for mid-size companies, contact Mark Jordan at Vercor, 770-522-0300, or go to www.VercorAdvisor.com.

"Even though I have over 1,000 patents to my name, I am not a great inventor, just a awfully good sponge. I absorb ideas from every source I can and put them to practical use."

Thomas Edison

Business Owner's Toolbox

Internet Access for Less

www.bigzoo.com, www.walmart.com, www.netzero.com

Just like long distance service, many of the big name Internet service providers charge much more than others. Try these websites for Internet service for under \$10 per month.

Prospecting and Prospect Databases

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Helpful tips that will help you more quickly find what you are looking for on the Net. Includes how to structure your query, how to use Boolean searches and metasearch engines, how to use web catalogues and indexes and much more, including other useful online resources.

Managing Marginal Tax Rates: A Basic Tax Reduction Tool

A key feature of our federal tax system is its progressive nature. Tax rates are higher at higher levels of income. Your marginal tax rate is the rate of tax you pay on your next dollar of taxable income. The rates for 2003 and 2004 start at zero then go to 10, 15, 25, 28, 33 and 35 percent. You can lower your tax bills by knowing your marginal tax rates and allocating income in a manner that minimizes the income that is subject to higher tax rates.

Example 1: Assume that you've had a good year in terms of income. You are married, file jointly, and determine your taxable income for 2003 to be \$165,000 currently — the total of interest income (\$10,000), salary (\$50,000), commissions (\$50,000) and pass-through earnings from your company (\$55,000). It is near year-end and you are close to completing a sale that will earn you \$50,000 in commission. Should you push to get it done before year-end or let it slip into 2003?

If we look at the federal tax rate table found on page 19 of this issue, we see that married couples filing jointly pay a 28% income tax rate for income between \$114,650 and \$174,700. Income over \$174,700 to \$311,950 is taxed at 33 percent. If the sale closes this year you will owe a total federal tax of \$16,015 on the additional \$50,000 of income, computed by applying the 28 percent rate to the \$9,700 left in the 28 percent tax bracket and applying the 33 percent tax rate to the remaining portion of the commission

income. If, however, you delay closing until next year when you expect your overall income to be lower, the income could be taxed at the 25 percent and/or 28 percent levels, saving you at least \$2,015 in federal tax (assuming the \$50,000 is all taxed at the 28 percent rate), and even more when you include state tax. A nice return considering how little effort is required.

Example 2: Joe Roe has calculated his taxable income, after regular and itemized deductions, at \$69,000 for 2003. He's had a great year, but he expects his income to be back to the typical range of 40,000 next year. Using the federal income tax tables for married filing jointly he sees that he is in the 25 percent tax bracket for all income over \$56,800. As such, he is paying 25% tax on \$12,200 of his income. He checks his personal payables for deductible expenses and sees that he is holding a real estate tax bill that is due March 15th of 2003 for \$7,000. Because many real estate taxes are deductible in the year they are paid, and this one is, he could go ahead pay the bill before year-end and reduce his 2003 taxable income by \$7,000. To the extent that next year's income will all be taxed at the 15% bracket, Mr. Roe would have saved \$700 in taxes, calculating the savings as the difference between the 25 percent and 15 percent tax rates multiplied by the \$7,000 of income that would have otherwise been taxed at 25 percent. □

Computer Security for the Business Owner, continued from page 4

- 3) **READ** the eradication instructions provided by your antivirus software. Each virus and Trojan horse has its own "signature" and method for removal. Carefully follow the directions. Microsoft's website is another source for eradication instructions.

Test the Vulnerability of Your Computers to Attack

There are two ways to assess the security risk of your computers. The first way is to hire a company like Network Frontiers (www.netfrontiers.com) to perform a full-scale security test on every computer in your company. This is a fee-based service, so naturally this option is for those that have special risk or can afford to invest the cash. Lucky for many of us, there are some very solid security assessment tools available on the Internet, for free.

Start with Steve Gibson's *Shields Up* — a comprehensive scanner available free at grc.com. Or visit Webtrends' site to request a free security scan (www.webtrends.net/tools/security/scan.asp), which will be sent to you via e-mail. You can also go to HackerWhacker (www.hackerwhacker.com) and click on Free Security Scan. Or, go to the Symantec Website (security.symantec.com) and run the Hacker Exposure and Trojan Horse checks.

Save Your Keester with Keester

If your business uses Intuit's new QuickBooks products (Pro 2003 or Premier), there's a backup solution that you just can't pass up. NovaStor (www.novastor.com/keester) has introduced a backup

device that fits on a key ring and, once inserted into the computer running QuickBooks, *automatically backs it up!*

The first time you insert the NovaStor Keester into your computer, a simple guide will walk you through the initial orientation and setup. When the setup is completed, you can plug in your Keester to automatically protect your QuickBooks data by sending backup copies to the key's one gigabyte of memory. Obviously, if the Keester is on your key ring, the data will be taken off site with you whenever you leave! □

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"No, the computers are up. We're down."

How to Get from “I’m Satisfied” to “I’m Sold!”

“I’m satisfied with my present supplier.”

Great, just what you wanted to hear. But don't get discouraged with this one. It's actually pretty easy to get an opening and begin a relationship if you can get the prospect talking. Just because he is satisfied now, doesn't mean he won't buy now. To do so, the first step is for you to realize that *what your prospect is saying is that their existing supplier is the best they've been able to find.*

You may have a better product, price, availability for delivery, service, training, or warranty. The prospect is only telling you he's satisfied from *his perspective, to the best of his knowledge.* He doesn't really know about you or your company yet. Here are some things you can do to get the “satisfaction” ball rolling in your direction:

- **Get information about the present vendor:** “How have you successfully used...” and “How did your present relationship begin?” and “What do you like about the vendor you're using?” and “Is there anything that bugs you about the relationship?”
- **Show a difference:** “We have recently introduced new technologies that go beyond your present equipment (or industry standard). Would you like to hear about these developments and how they can benefit companies like yours?”
- **Issue a challenge:** “I'm sure you will agree, Mr. Prospect, that as a businessman, you owe it to your business to continue to actively seek out the best value.” A satisfied buyer may indicate a complacent supplier. Offer to do all the comparative work.
- **Give an experienced response:** “Mr. Jones, when I personally have a satisfactory vendor, I still need another vendor as a point of reference to make sure I'm getting the best price, selection of products and value.”
- **Question his selection process (not his selection):** “What standards do you judge your vendors by?” Raising the question of standards will get the prospect thinking about future performance not just past.

Your challenge is to position yourself to where there is a CHANCE for you to earn the business. You simply need the prospect to either doubt the present supplier or have enough confidence in you to take a risk. This position must be established BEFORE you can get an order.

Here are 5 keys to help you create opportunities for order-positioning...

1. **Find out how the relationship with his present source began.** Get a historical perspective. Find out how he began with his present supplier. Ask the prospect what gave him the confidence to go with (the competition) when he made that decision some time back? Ask if he would be willing to take the same small risk in you, so that you could earn the business.



**Jeffrey
Gitomer**

2. **Ask the two important open-ended questions:** “What are the things you like about the vendor?” and “What would you improve if you could?”

3. **Create some doubt:** “Mr. Prospect, if you were (pick one) – a. paying 20% too much; b. not getting full value; c. not taking full advantage – from your present supplier, how would you know it?” OR (when he or she is buying from a friend) “If it wasn't for the friendship, would you still buy from the company?”

If you get a chance to give some information, you'd better make it sound great. Be sure to stress that you have long-term relationships with your customers. Build confidence. Tell the prospect you're interested in slowly cultivating one with him and you don't expect a total switch, but an evolution and proof by performance. Say you'd like the same opportunity you gave (present supplier) back when you issued him that first order.

4. **Employ the What's best for your company strategy.** You say, “Mr. Johnson,

I'm sure in the long run you want to do what's best for the company, don't you? And even though you're satisfied at the moment, that does not necessarily mean that your existing relationship is the best there is, does it? I believe we can help your company (insert reason) and I'm asking you to explore the possibilities of something better than you have now. Is that fair enough?

5. **Go for the sample or trial order.** Something small to get your foot in the door, and *prove* your worth to the prospect. If you sell a product that isn't “all-or-nothing” (printing, clothing, computer repair, ad specialties, photography) go for a test or trial.

If the prospect has a good long-term relationship with their present supplier - and you really want the business - and you really believe you can help your prospect improve themselves or their business - start building a relationship now.

Go slow, start small, but make plans to win big. ☐

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Basics of Tax Planning

Tax planning is the process of looking at various tax options in order to determine *when, whether, and how* to conduct business and personal transactions to reduce taxes. As an individual taxpayer and business owner you will often have options as to when and how to complete a taxable transaction. You have the right to choose the timing and method that results in the lowest tax liability. There is nothing wrong or illegal about tax planning or tax avoidance, as long as you don't use illegal means. Illegal means includes deceit, subterfuge or concealment in one or more of the following categories:

- Failure to report income
- Claiming fictitious or improper deductions
- Improper allocation of income to a related taxpayer who is in a lower tax bracket

Every tax planning strategy is based upon structuring a transaction to accomplish one or more of the following often-overlapping goals:

A. Lower Taxable Income.

By lowering taxable income, one lowers the amount of taxes due. Many strategies to reduce taxable income will simply delay or defer the recognition of income, which is valuable given the time value of money. Other tactics include increasing tax-deductible expenses, moving income to other taxable entities, or finding losses to offset investment gains. For more detail, see articles herein titled *Tax Planning for Businesses*, *Tax Planning for Individuals and Families*, and *Ways to Lower the Applicable Tax Rate*.

B. Claim All Available Tax Credits.

Tax credits are dollar for dollar reductions to your tax bill. Deductions are dollar for dollar reductions of your taxable income. There is a big difference. Tax credits are much more valuable than deductions because a \$100 credit reduces your tax bill by \$100, regardless of your tax bracket. In contrast, a deduction simply

reduces your taxable income by the product of the deduction amount times the applicable tax rate. For example, if you are in the 33 percent tax bracket, a \$100 deduction will reduce your taxes by \$33.00. For a review of tax credits available, see articles herein titled *Tax Planning for Businesses* and *Tax Planning for Individuals and Families*.

C. Lower The Applicable Tax Rate.

Such strategies include the rationalization of taxable income between tax years in light of marginal tax rates (see article herein titled *Managing Marginal Tax Rates*); moving income to persons or entities that are taxed at lower levels; moving income into accounts that are non-taxable or tax deferred; or conducting transactions in a manner that qualifies for lower rates (such as long-term vs. short term capital gain rates). See also articles herein titled *Ways to Lower the Applicable Tax Rate*, *Tax Planning for Businesses* and *Tax Planning for Individuals and Families* for more detail.

D. Control The Effects Of The Alternative Minimum Tax (AMT).

The AMT was established in 1986 to ensure that higher income individuals and corporations pay at least a basic level of tax, regardless of the number of tax credits and deductions that they garner. It requires that federal income taxes be calculated by two separate and distinct methods — regular tax laws and AMT laws. You pay the higher of the two. C-corporations with annual revenues under \$5 million (and in some cases up to \$7.5 million) are exempt. Individual taxpayers that have incomes over \$75,000 face heightened risk of triggering AMT taxes. AMT tax rates are lower, such as 26 percent and 28 percent for individuals, but far fewer credits and deductions are allowed. For more information, see articles in this issue titled *Tax Planning for Businesses* and *Tax Planning for Individuals and Families*. □

Tax Planning for Businesses

As explained in the accompanying article titled *The Basics of Tax Planning*, every tax planning strategy is based on structuring transactions to accomplish one or more of the following often-overlapping goals:

- Lower current taxable income
- Claim all available tax credits
- Lower the applicable tax rate
- Control the effects of the alternative minimum tax (AMT)

Here is a list of suggestions for applying each of these basic strategies to your business.

WAYS TO LOWER THE CURRENT TAXABLE INCOME OF YOUR BUSINESS:

Maximize the Expenses That Are Recognized In The Current Year. Do so by paying (if you use the cash basis) or booking (if you use the accrual basis) expenses in the current year that might otherwise be recognized in future years. This is accomplished by incurring the expenditure before year-end by issuing a purchase order or paying expenses such as rent, insurance or taxes. Talk to your accountant about your particular situation.

Contribute To A Qualified Retirement Plan. Employer contributions to qualified retirement plans are tax deductible.

Qualified plans generally mean employer sponsored pension, profit sharing or stock bonus plans that meet requirements of Internal Revenue Code section 401(a), or an annuity that meets requirements of Internal Revenue Code section 404(a)(2). There are three types of qualified plans: defined contribution, defined benefit and hybrid. If you do not have a qualified plan in place, talk to an attorney, accountant or benefits plan expert. In some cases, regulations may require that a plan be put in before the end of this year to be fully utilized next year.

Increase or Accelerate Charitable Contributions. Donating to a worthy cause not only does good but can reduce your

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Tax Planning for Businesses, continued from page 10

taxable income. Advancing next year's payment might be considered as well, as many nonprofit organizations now accept credit cards. The charity will appreciate the earlier receipt of the money and you get a deduction. Empty your closets of old clothes, furniture and the like and donate them to a charity. Remember to get a receipt and figure out the fair market value of the goods you donate. If you're audited, no receipt means no deduction.

WAYS TO FIND, QUALIFY FOR AND CLAIM BUSINESS TAX CREDITS:

A corporation can take a dollar for dollar reduction of its tax liability for any tax credit for which it qualifies, making tax credits an extremely powerful tool for tax reduction. Most federal tax credits currently available to small businesses, however, are very narrowly targeted to encourage you to take certain actions that lawmakers have deemed desirable. There are also a few credits designed to prevent double taxation, and a few designed to encourage certain types of investments that are considered socially beneficial. The credits can be divided into four categories:

Credits For Certain Taxes. Credits are permitted to offset the sting of certain taxes, including FICA taxes on tips for food and beverage establishment employees, foreign taxes, a portion of prior alternative minimum tax (AMT) liability, and gasoline taxes paid by farmers or off-highway-vehicle users.

Credits For Activities That Benefit Disadvantaged Or Low-Income Persons. There are a number of credits designed to encourage employment or investment that benefits certain groups: the welfare-to-work credit, the disabled access credit, the empowerment zone employment credit, the Indian employment credit, the low income housing credit, the credit for contributions to Community Development Corporations, and the work opportunity tax credit.

Credits For Activities That Benefit The Environment.

Currently, the largest group of credits are those for investment in equipment or processes that save energy or protect the environment in some way: alternative fuels, qualified electric vehicles, reforestation, energy, alcohol fuel, enhanced oil recovery and renewable resource electricity production.

Credits For Certain Other Investments. The smallest (and shrinking) group of credits relates to certain investments that are deemed socially beneficial: rehabilitation of old or historic buildings, orphan drug programs and research and development.

WAYS TO LOWER THE APPLICABLE TAX RATE:

There are a number of strategies for lowering the applicable tax rate. See the article in this issue of *The Business Owner* titled "Ways to Lower the Applicable Tax Rate."

WAYS TO CONTROL THE EFFECTS OF THE CORPORATE ALTERNATIVE MINIMUM TAX (AMT):

The corporate alternative minimum tax (AMT) applies to C-corporations only. It was established in 1986 and has been weakened by laws enacted in 1993 and 1997. Small corporations generally are exempted from the AMT if they had average gross receipts of less than \$5 million for the first three taxable-year periods beginning after December 31, 1993. If this is true, then a corporation will continue to qualify for the exemption as long as its average three year gross receipts do not exceed \$7.5 million. Studies have shown that many small corporations are unaware of their exemption to AMT and erroneously pay tax under the AMT. The first step to minimizing the effects of the AMT is to find out if you are exempt. If not, consult your tax advisor. The corporate AMT calculations are complex, as is determining which tax credits can and cannot be applied against the AMT. □

Coming Up in *The Business Owner*

The Power Of Time and Compounding of Investment Returns
 ■
Business Owners Should Serve Themselves As Well As Others
 ■
Small Business Health Plans

Disability Insurance
 ■
Writing a Business Plan In One Hour/Refining It With 20 Minutes a Week
 ■
Switching Costs and Substitution
 ■
Alternative A/R Financing

Small Disadvantaged Business Status, Explained
 ■
What To Look For In a Business Appraiser
 ■
Responsibilities Of Company Board Members

Background Checks
 ■
The Business Owner's Big Three
 ■
Corporate Books and Records – What To Do
 ■
Company Officers and Non-Officer Employees

If you need to renew, or have any comments or questions, just call us at (800) 634-0605 or email info@TheBusinessOwner.com.

Tax Planning for Individuals and Families

The income tax owed by individuals is calculated as follows:

+ Total Income	Line 1
- Deductions	Line 2
= Adjusted Gross Income	Line 3
- Itemized Deductions	Line 4
= Taxable Income	Line 5
- Tax Credits	Line 6
= Total Tax	Line 7

To reduce the total tax bill (i.e. the bottom line result of the above equation), one must do one or more of the following:

- Reduce total income as calculated by the IRS (line 1 above)
- Increase deductions (line 2 above)
- Increase itemized deductions (line 4 above)
- Increase tax credits (line 6 above)

Furthermore, as described in the accompanying article titled *The Basics of Tax Planning*, one must attempt to mitigate the effects of the alternative minimum tax (AMT).

1) REDUCE TOTAL INCOME

One way to reduce your tax bill is to lower the amount of income that is subject to taxation. This notion may seem counterintuitive at first, but there are things that can be done to obtain income or income-like benefits that fall outside of the IRS's definition of income. Here are some ideas:

Defer Income. If delaying income to next year would result in a lower tax rate, or if you simply want to delay the payment of tax to obtain the use of the money for another year, consider ways to delay the receipt of the income. Watch out, however, for the strict rules that govern when income is earned, referred to as a "constructive receipt".

Move or Increase the Amount of Capital In Investments That Generate Non-Taxable Income. Certain state and local bonds offer a yield that is free of federal tax and, if you live in the state or locality from which they were issued, free of state and local tax. U.S. Treasury bills, notes and bonds yield interest income that is exempt from state and local taxes. In addition, the tax benefit of these investments increase in value as your marginal tax rate rises. For example, if you are in the 35 percent bracket, a 5 percent tax-free rate becomes equivalent to a taxable rate of 7.69 percent. In the 15 percent bracket, the taxable equivalent is only

5.88 percent. Before you invest, however, confirm the tax-exempt status of the bond and the financial stability of the entity that will be repaying your invested funds.

Utilize Capital Losses. Capital losses, such as losses in investments in publicly traded stocks, may be used to offset capital gains dollar-for-dollar up to the amount of any gains realized on other investments. In addition, up to \$3,000 in capital losses that exceed capital gains may be used as a deduction against ordinary income. If you have investments that are selling for less than you paid for them, consider cashing out of your position to the extent that a loss is generated to offset gains plus \$3,000. If you think the stock has a bright future you can invest back into the stock after 30 days and not risk running afoul of "wash sale" rules.

Select Investments That Generate Little or No Income.

An alternative to current income is future income. Most publicly traded stocks pay few if any dividends and offer the potential for capital appreciation. Capital gains are not taxed until they are realized (sold). Some bonds may offer some deferral of income as well.

Move Funds Into Education or Retirement Accounts That Are Sheltered From Tax. Income generated on investments held in retirement accounts is not taxable. In many cases, the contribution amounts may be deductible as well.

Home Sale Exclusion. Home sales offer a tremendous opportunity for tax-free income. With the new laws, you don't have to reinvest the money and you can claim the exclusion every two years!



2) INCREASE REGULAR DEDUCTIONS

The second step in lowering individual taxes is to maximize the allowable "regular" deductions. These deductions should not be confused with itemized deductions which appear on schedule A. These "regular" deductions can be made whether or not you itemize. In addition, don't confuse the term deductions with exemptions. Exemptions are a completely different type of deduction and are independent of the decision of whether to itemize or not. Below is a list of the allowable "regular" deductions:

Individual Retirement Account (IRA) Contribution. If you are not covered by a retirement plan at work, or if you are but earn less than \$40,000 in 2003 (married filing jointly), you may contribute up to \$3,000 for the tax year 2003 (to be contributed by April 15, 2004) and deduct the entire amount. Earnings within the account also accrue tax-free.

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Tax Planning for Individuals and Families, continued from page 12

Student Loan Interest. If you paid interest on a student loan in 2003 you may be eligible to deduct some or all of it, whether the loan was for your own education, your spouse's, or that of a child or anyone else who was your dependent at the time the education was undertaken. The maximum deduction is \$2,500 per year. Watch for 2003 phase-outs that begin at adjusted gross income (AGI) of \$50,000 for singles and \$100,000 for joint return filers.

Medical Savings Account (MSA). Individuals who are self-employed, or who participate in a health insurance plan of an employer that averaged no more than 50 employees during the two preceding years may create a deductible Archer MSA account. This account may be used as a vehicle for deducting from taxes a portion of the funds that go towards meeting the medical expense deductible of the insurance plan. The insurance coverage must meet some requirements, and the MSA contribution/deductible amount is limited to 65 percent of the individual deductible or 75 percent of the family deductible.

Health Insurance Payments. If you are self-employed and pay medical insurance premiums for you and your family, you may be able to deduct 60 percent of the premium cost. If you choose to itemize, you can also deduct any amount not deducted here along with other unreimbursed medical costs ... subject to the 7.5 percent of AGI limitation.

Moving Expenses. To qualify, your new place of employment must be at least 50 miles farther from your old residence than your former job was from your old residence. There are also stipulations for how long you were employed at your old employer and how long you remain employed at your new employer. Consult your advisor.

Alimony Payments. A tax-deductible expense to the payer in the year that the expense is paid. Alimony payments are considered taxable income to the payee in the year that such payments are received.

Education Expenses. Up to \$3,000 (\$4,000 in '04 and '05) may be deducted for "qualified education expenses" for post-high school academic or vocational courses. It is limited to tuition and fees for the taxpayer or dependents. This deduction cannot be claimed in the same year as the Hope or the Lifetime Learning Credit discussed below, and is phased out for couples with modified adjusted gross income over \$139,200 and singles over \$69,200.

3) INCREASE ITEMIZED DEDUCTIONS

Every taxpayer may take the standard deduction of \$4,750 in 2003. However, if your itemized deductions total a higher number you will want to itemize and use the higher number. The only way to find out is to go through the exercise. In some cases, however, you don't have a choice. For example, if your filing status is married filing separate and your spouse itemizes, then you must also itemize.

Some itemized deductions can only be taken if they exceed certain levels. Miscellaneous itemized deductions such as tax preparation fees, employee expenses and investment costs can be taken only if they exceed 2 percent of your AGI. If your itemized deductions in any given year don't exceed the standard deduction, consider trying to combine payment of these types of expenses into one

year so you can exceed the limit and take the deduction every-other year.

Home Mortgage Interest, Points and Investment Interest.

Home mortgage and investment interest are the only types of interest expense that are deductible for individuals, except interest expense incurred in a business. The IRS definition of "home," referred to as a "qualified residence," can include condominiums, cooperatives, mobile homes, boats, recreational vehicles and time-share units. The home must simply have basic living and sleeping accommodations. Interest incurred on debt associated with the ownership of a second residence may be deductible as well. Investment interest expense is only deductible to the extent of net investment income. Points paid on a primary residence may be deducted either in the year paid or over the life of the loan. Points paid for a second residence must be amortized over the life of the loan.

To lower taxes and the effective cost of borrowing, persons that have equity in their home(s) and also have consumer debt, such as balances on credit cards, should consider paying off such debt with a home equity loan or refinancing of their first mortgage.

State and Local Taxes, Real Estate Taxes and Personal Property Tax. Subject to phase out for high-income individuals, state, local, personal and real property tax costs may be deducted in the year they are paid. Individuals should consider the timing of actual payment of such taxes in light of marginal tax rates.

Increase, Accelerate or Make Tax-Wise Charitable Contributions. Donating to a worthy cause not only does good but it can reduce your taxable income. Advancing next year's payment might be considered, as many nonprofit organizations now accept credit cards. The charity will appreciate the earlier receipt of the money and you get a deduction. Empty your closets of old clothes, furniture and the like and donate them to a charity. Remember to get a receipt and figure out the fair market value of the goods you donate. If you're audited, no receipt means no deduction. If you donate property, the deduction is generally equal to the fair market value of the property at the time of the donation, as long as the property was held for more than one year. As such, a powerful way to reduce taxes and maximize deductions is to donate appreciated assets. Doing so will save you from owing tax on the capital gain and you will still be able to deduct the full, appreciated value of the stock.

Unreimbursed Health, Medical and Dental Expenses. This deduction is limited to the amount that exceeds 7.5 percent of your adjusted gross income. If you own a company but don't offer a health insurance plan, consider adding one. As long as the plan has a rational basis for any discrimination (i.e. excluding any employees), then your company can deduct the expense and you

One way to reduce your tax bill is to lower the amount of income that is subject to taxation. This notion may seem counterintuitive at first, but there are things that can be done to obtain income or income-like benefits that fall outside of the IRS's definition of income.

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Tax Planning for Individuals and Families, continued from page 13

and your dependents may be able to receive the benefits tax-free or on a tax-advantaged basis.

Casualty, Theft or Disaster Loss. If you suffer from a loss of property due to theft or a sudden, unexpected or unusual event, you may be able to claim a loss equal to the lesser of your adjusted basis or fair market value, net of any reimbursement from an insurance company. Such expenses may be deducted only to the extent that they exceed 10 percent of AGI. If you suffer loss to personal or business property resulting from a disaster occurring in an area that has been designated a disaster area entitled to federal assistance, you have the added option to deduct the loss on the prior year's tax return, which serves to accelerate the benefit. The deductible portion of such losses is still limited to the amount that exceeds 10 percent of AGI.

Education Expenses and Miscellaneous Deductions. To the extent that education expenses are not available for a regular deduction or credit, they may be deductible as an itemized expense if required by your employer. These expenses are only deductible to the extent that they, along with all other miscellaneous itemized expenses, exceed 2 percent of AGI. Deductible miscellaneous expenses are mostly related to expenses incurred in the pursuit of taxable income such as legal fees, investment fees, uniforms, professional subscriptions, job search costs, union dues, professional association membership and unreimbursed expenses incurred on the job.

Note on Phase-out of Itemized Deductions. Many deductions have provisions whereby the deduction allowance is "phased-out" as the taxpayer's income rises past certain levels which vary by deduction. Medical expenses, investment interest expense, casualty and theft losses and gambling losses are not subject to phase out due to income levels but all other deductions are reduced by 3 percent of the amount by which your AGI exceeds the particular income threshold. The purpose of having phase out rules is to increase the effective tax rate paid by wealthier taxpayers . . . without having to add additional tax brackets. By enacting such rules, Congress can seem to lower tax rates for everyone while actually increasing taxes on wealthier taxpayers.

4) INCREASE TAX CREDITS

Tax credits are dollar for dollar reductions to your tax bill. Deductions are dollar for dollar reductions of your taxable income. There is a big difference. Tax credits are much more valuable than deductions because a \$100 credit reduces your tax bill by \$100, regardless of your tax bracket. In contrast, a \$100 deduction simply reduces your taxable income by \$100 and your tax bill by \$25 (if you are in the 25% percent tax bracket). Regardless, both serve the same purpose of lowering taxes. Use this list as you begin to assess the credits that might be available to you. This list is not comprehensive and there is not room here to list all the stipulations of each. Work with your tax advisor to find all the tax credits for which you could qualify.

Child Tax Credit. Every family with an annual income of less than \$110,000 (\$75,000 for single parents) qualifies for a \$1,000 credit for each dependent child, stepchild, grandchild or foster child under the age of 17.

Adoption Tax Credit. Up to \$10,160 for expenses not reimbursed by your employer, and an exclusion of up to \$6,000 paid under an employee benefit plan that pays for adoption expenses. Both tax breaks begin to be phased out for those with adjusted gross income over \$152,390 in 2003.

Dependent Care Expense Credit. If you incur child care expenses so you or, if married, you and your spouse can go to work, you may be able to deduct 20 percent of your expenses — up to \$3,000 per child for a maximum of \$6,000. The child must be your dependent and under 13 years old or physically or mentally unable to care for themselves.

Elderly and Disabled. A \$5,000 credit (\$7,500 MFJ) is available to certain low-income individuals 65 year of age or older, and to individuals under age 65 if they are retired with a permanent and total disability and have taxable disability income from a public or private employer. The income limits are low.

Elective Contributions to

Retirement Plans. Low-income earners in 2003 may take as a tax credit up to 50 percent of elective contributions to an employer sponsored retirement plan or IRA, up to \$1,000. Phase-out provisions begin at \$30,000 AGI for married filing jointly and \$15,000 for married filing separately. This new law allows a 15 percent tax-rate taxpayer to contribute \$2,000 to a retirement account and receive back \$1,300 — \$1,000 from the tax credit and \$300 from the \$2,000 deduction.

Hope Scholarship Credit. If you, your spouse, or a dependent was enrolled at least half-time in the first or second year of college, you may be able to deduct the first \$1,000 of qualified expenses incurred, and 50 percent of the next \$1,000, for each student in your family who meets some fairly modest requirements. The credit is phased out for joint filers between \$83,000 and \$103,000 of income and for single filers between \$41,000 and \$51,000.

Lifetime Learning Credit. For those who already have two years of college and can't qualify for the Hope credit, the Lifetime Learning Credit provides a smaller tax benefit for an unlimited number of years in which you take postsecondary educational courses. You can claim the credit for yourself, your spouse if filing jointly, and for any dependents for whom you claim an exemption on your tax return. This credit is worth 20 percent of the first \$10,000 in higher education expenses *per family*. Therefore, the maximum amount of credit you can claim is \$2,000.

Social Security Tax. If you changed jobs in 2003 and expect to gross more than \$87,000, you may have paid too much social security tax. You're liable for social security tax only on the \$87,000, but both employers are required to pay their shares. If you paid too much, you can get it back with a tax credit against your income tax liability.

Tax credits are dollar for dollar reductions to your tax bill. Deductions are dollar for dollar reductions of your taxable income. There is a big difference.

continued on page 15

Tax Planning for Individuals and Families, continued from page 14

5) TAME THE AFFECTS OF THE AMT

Although the alternative minimum tax (AMT) was intended to apply to high-income taxpayers, especially those that take advantage of tax loopholes, it can also apply to middle-income taxpayers who have not engaged in some tax planning. In fact, the AMT is hitting more and more taxpayers each year. The only deductions allowed under the AMT are for mortgage interest and charitable contributions. Therefore, even though the AMT doesn't look so fierce when you look at its tax rates — 26 percent and 28 percent compared to the 35 percent top income tax rate for 2003 — more income is taxed, so it always produces a higher tax bill. To figure out if you're in the AMT you must calculate your taxes under the AMT system and under the regular income tax system. You pay the higher of the two.

Personal Exemptions. While personal exemptions can be used to reduce your tax bill under regular IRS rules, they are not allowed for AMT purposes. Taxpayers with many children often run afoul of the AMT due to this provision, and it's hard to avoid. Sometimes the best defense is to simply take extra care in planning other tax items that could help you avoid the AMT.

State and Local Taxes. State, local, and other taxes paid and claimed as itemized deductions are not allowed as deductions for AMT purposes. As such, persons that live in high tax states have more trouble with the AMT. One strategy is attempting to pay state and local taxes in years when you won't face the AMT, because otherwise they will give you absolutely no tax relief. Keep in mind that real property taxes cannot be deducted until they are

The second step in lowering individual taxes is to maximize the allowable "regular" deductions. These deductions...should not be confused with itemized deductions.

actually paid to the taxing authority. So, if you pay property taxes through a mortgage lender, the lender's cooperation in paying the taxes before a due date will be required to achieve your objective. Also, even when a delay in payment of property taxes could incur penalties, the tax savings could be well worth it.

Medical Expenses. Medical expenses can be deducted for AMT purposes, but they must exceed 10 percent of adjusted gross income, compared to 7.5 percent as a regular itemized deduction. Thus, as with the deduction for state and local taxes, you might be able to time medical deductions to maximize medical expenses in non-AMT years. Again, medical problems and expenses aren't something that you can usually plan, but you do have a bit of control over when you pay medical bills. So, think about the acceleration and deferral methods that we discussed above when dealing with medical expense payments.

Miscellaneous Itemized Deductions. Miscellaneous itemized deductions that are greater than 2 percent of your adjusted gross income are deductible for normal tax purposes, but they are not deductible for AMT purposes. These expenses include unreimbursed employee business expenses, expenses for the production of income, tax return preparation expenses, and many others too numerous to mention here. And, you do have much

more control over these expenses. So, if they are large, make sure to do your AMT planning so you don't lose the tax benefit of these expenses.

Capital Gains. Investment gains are taxed under the AMT at the regular and more desirable capital gains rates, but large amounts of capital gain income could trigger AMT taxes. If you've done well with your long-term investments and are looking to liquidate, review your AMT situation and determine what impact such a sale would have. You might be able to make decisions that will minimize your AMT taxes, such as selling only part of the investment in each of two or three tax years.

Incentive Stock Options (ISOs). If you receive ISOs from your employer, watch out. The bargain element (the difference between your exercise price and the fair market value of the stock on the exercise date) is considered a tax preference for AMT purposes. While you'll owe no regular tax on this bargain element, the AMT could certainly kick in. ISO issues are much too complicated to discuss here in any detail. Just know that if you are exercising ISOs you potentially have big AMT issues. Make sure you know where you stand with your AMT before you exercise.

Avoid Private-Activity Bonds. There is a certain kind of municipal bond called a private activity bond that loses its tax-free status under AMT. Private activity bonds are issued by private companies for projects that benefit the public, such as airports, seaports and stadiums. If you're worried about being bumped into the AMT or you're in it, you will probably want to avoid private-activity bonds. □

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Which is More Valuable: Increasing Sales, Lowering Costs or Cutting Taxes?

You work hard to increase sales and reduce costs. Both are essential for profitable growth. But it may surprise you to learn that, from a pure cash-in-your-pocket point of view, a tax dollar saved is much more valuable than an additional sales dollar or cost-savings dollar.

The reason: A tax dollar saved is a full dollar retained in the business. Federal and state taxes take a bite out of every other business dollar. Here's the proof.

Tax Savings vs. Sales Increase.

The following formula yields the sales necessary to match any amount of tax dollar savings.

$$\frac{\text{TAX DOLLARS SAVED}}{(1 - \text{Tax Rate}) \times (\text{Profit Margin } \%)} = \text{Sales Equivalent}$$

Example: Company A has a 10 percent pre-tax profit margin (pretax profit divided by revenue) and is in an overall 35 percent tax bracket (federal and state). Tax planning saved \$10,000 in taxes. The tax savings is equivalent to the profit on \$153,846 in additional sales, computed as follows:

$$\frac{\$10,000}{(1 - .35) \times (10\%)} = \$153,846$$

The \$10,000 tax savings provided Company A with the after-tax equivalent of \$153,846 in additional sales. Any tax dollar saved would yield the after-tax equivalent of \$15 in increased sales (\$154,000 / \$10,000).

Tax Saving vs. Cost Cutting.

Now let's compare the value of a \$1,000 tax savings with that of a

\$1,000 cost reduction. Use the table below, which again assumes an overall 35 percent tax rate.

Sales Equivalent: Tax vs. Cost Savings

Pretax Profit Margin	Sales Necessary to Match \$1,000 Tax Reduction ⁽¹⁾	Sales Necessary to Match \$1,000 Cost Reduction ⁽²⁾
20%	\$7,692	\$5,000
15%	\$10,256	\$6,667
10%	\$15,385	\$10,000
8%	\$19,231	\$12,500
6%	\$25,641	\$16,667
4%	\$38,462	\$25,000

(1) See first formula above

(2) To compute the sales equivalent, simply divide your cost savings by the profit margin (e.g., \$1,000 divided by 20% equals \$5,000 in sales).

As shown, if your profit margin is 15 percent, a \$1,000 savings in taxes is equivalent to additional sales of \$10,256 – about 1.5 times the \$6,667 amount you would realize from cutting costs by \$1,000. And the lower your pretax profit margin, the more valuable tax savings are to you. From example, if your profit margin is only 5%, a \$1,000 tax savings is equal to \$38,462 in sales!

When the goal is after-tax cash in your pocket, adding revenue and lowering expenses is paramount. However, tax reduction is critical as well. Dollar for dollar, the value of a tax dollar saved is unmatched. □

Substitution, Switching and Switching Costs, continued from cover

example, the development of cheap commercial air flight took customers away from passenger trains. Fiberglass snow skis provided a substitute for steel skis, and snowboards have provided a substitute for snow skis altogether. More broadly, winter vacation alternatives, such as snow skiing, compete with summer vacations options for our limited vacation time each year.

When looking for substitute threats, look at alternative products as in the above examples. But substitutes can also come in these forms:

- **Buyer does not purchase anything at all.** For example, he decides not to eat eggs anymore due to cholesterol. Or, a business discontinues offering a certain product, thereby eliminating the need for you to supply component parts.
- **Lower usage rate.** For example, aluminum can manufacturers are making the walls of the cans thinner, reducing the aluminum usage. Or, new, highly reliable heat and air units are reducing the demand for repair and maintenance services.

- **Used, recycles or reconditioned products.** For example, manufacturers need tooling. They can buy new tooling; recondition their own tools or buy already reconditioned ones.
- **Backward integration.** For example, a customer that has historically bought through your distribution company could decide to begin buying direct from the manufacturer.

Business owners are much more prone to not take the threat of substitutes seriously enough, and be blindsided by a substitute to their product or service, than to take these threats too seriously.

Switching Costs: Barriers to Switching

Substitution, or a buyer's changing from one product or service to another, always involves some costs. The higher the cost of switching, the more difficult to switch. Switching costs create barriers to switching which can either protect your product or service from threats of substitution or prevent potential buyers from switching to your product.

continued on page 18

Ways to Lower the Applicable Tax Rate

Strategies for lowering the rate at which income is taxed include the rationalization of taxable income between tax years in light of marginal tax rates, moving income to persons or entities that are taxed at lower levels, moving income into accounts that are non-taxable or tax deferred, and conducting transactions in a manner that qualifies for lower rates (such as long-term vs. short term capital gain rates).

Allocate Income Among Years to Avoid Higher Tax Brackets.

This technique, known as Marginal Tax Rate Analysis, is explained in more detail in the accompanying article titled *Managing Marginal Tax Rates: A Basic Tax Reduction Tool*.

Hold Appreciated Investments Long Enough to Qualify for Long-Term Gains Treatment.

Investments held for less than one year are taxed at ordinary income tax rates, which are higher than capital gains rates. Investments held for more than a year are taxed at long-term capital gain rates, which are lower at all income levels. A rate that is even lower may be available for transactions occurring after December 31, 2000, if the asset is held more than five years.

Make Charitable Contributions with Appreciated Assets Instead of Cash.

Doing so will save you from owing tax on the capital gain and you will still be able to deduct the full, appreciated value of the stock (if you have held the investment more than a year).

Gift Money, Assets or Investments to Entities that Enjoy Lower Tax Rates.

Any person can give \$11,000 in cash or property per year to any person or persons, with no income tax or gift consequence to either party. This tax code provision is most often used to move assets to children and grandchildren because the amount transferred will not be subject to estate and/or generation-skipping tax. It is an effective tool for moving income generating assets to persons that enjoy lower tax rates. As long as the gift is \$11,000 or under, there is no reporting requirement. Additionally, one spouse may give \$22,000 and as long as the amount is reported and both spouses consent on the return, the amount will not be taxable.

Shift Income to Entities Domiciled in Cities, States or Countries with Lower Overall Tax Rates.

City, County, State and Country taxes vary significantly. Businesses that have multiple locations of operation and/or a non-local client base, and even individuals, should consider how taxes could be reduced if income could be attributed to another locale. □

One spouse may gift \$22,000, and as long as the amount is reported and both spouses consent on the return, the amount will not be taxable.

“Rudderless ships are only good at drifting”

Deductible Year-End Charitable Giving

If you plan to make an end-of-the-year charitable contribution, here are some points to consider:

- Donations of clothing and household items to the Salvation Army and similar charities made before January 1, 2004, are deductible on your 2003 taxes. Even though the deduction is limited to the lesser of what you paid for the item or its current fair market value (generally, what you could sell it for at a garage sale), this deduction can add up. Be sure to get a receipt from the organization to which you donate.
- Donations of appreciated capital-gain type property, such as stock, can be very valuable. Even though you use the higher fair market value as your charitable deduction, you don't have to report the gain on your tax return. You also don't incur any out-of-pocket cost except, perhaps, typically a small fee to transfer the asset to the charity. Note, however, that the AGI (adjusted gross income) limit for this type of contribution is 30 percent rather than the usual 50 percent limit.
- Temporarily short on cash? You can make your contribution by credit card before the end of the year and take the deduction on your 2003 return ... regardless of when you pay off your credit card.

One caveat: The Alternative Minimum Tax could get in here way. Talk to your accountant about the complex AMT rules before you count on the deduction. □

Did You Know ?

Entrepreneurship is on the rise. According to the *Global Entrepreneurship Monitor*, nearly 12 percent of U.S. adults were recently involved in a company that had been formed within the past four years. This is up from nine percent in 1999.

Substitution, Switching and Switching Costs, continued from page 16

Switching costs include the direct costs of the alternative product or service as compared to the established product or method, as well as the indirect costs associated with switching to the new alternative. Indirect costs include how the alternative product or service affects other parts of the buyer's business. For example, switching to in-house printing of some multi-color fliers will require the purchase of a color printer, but might also require the purchase of other software and hardware, additional labor, or the trainings of existing labor.

Relative Price/Value: How Buyers Decide Whether to Switch

Buyers, formally or informally, decide whether or not to switch by comparing the real and/or perceived value that they expect to get from each option, compared to the costs associated with each. So, each alternative – existing method versus the new substitute method – has a price/value ratio.

When the buyer has not used a certain product or service before, it is the perceived value of using the product that is most important. If you are trying to get a buyer to switch to your product or service, your task will be to get the buyer to believe that the value offered by your products is greater than the value offered by their current method or source. More specifically, your challenge will be to help them understand that the price/value ratio for your offering is superior to the price/value ratio of their existing means for fulfilling their particular needs. For insight into how to do this, see the article titled "Customer Purchase Criteria and Signaling" in the July/August 2003 issue of *The Business Owner*.

Promoting Substitution

Expansion strategy for your business should include the finding of new markets for your product or service. When an alternative use/market is identified, consider the following as you formulate a plan for penetrating the market and getting customers to switch to your product or method:

Target Early Switchers: Some buyers are more apt to try new things. These types of buyers may be identified in various ways, such as companies that are under pressure or threatened in some way that might make them desperate to find new ways to reduce costs or offer more value to their customers. Or, they may be firms that simply have a history of adopting new ways and embracing change more rapidly.

Subsidize An Early Adopter: The power of testimonials is substantial. The risk that a buyer perceives in adopting your new method will be a barrier to their switching. By reducing their risk, somehow, such as by improving the potential price/value ratio, you could aid their choice to adopt. Then, testimonials for this customer can be used to lower the perceived risk felt by other buyer prospects.

Target Uses or Customers that Stand to Gain the Most: As perceived or potential value rises relative to the perceived costs, the propensity to switch will increase. That is, customers will switch more readily. So, it makes sense to identify the buyer prospect types that stand to gain the most by your new product or service, to achieve more rapid penetration.

Defending Against Substitutes

The first step in defending against substitutes is to identify them. This task can be difficult, but start by talking to customers that you lost. Also, talk to your peers via your industry association. Find out what they are learning, to whom they are losing customers, what is causing pricing pressure, industry developments, etc. Strategies to combat substitutes are the reverse of the steps described above to promote substitutes, and include:

- Improve the price-to-value proposition of your offering
- Raise switching costs
- Block attempts to lower switching costs and perceived risk of switching
- Find new uses for the product or service that are not threatened by substitutes
- Redefine the competition away from the strengths of the substitute
- Enlist suppliers in the defense against the substitute
- Redirect strategy to those markets that are least vulnerable to the substitute
- Enter the substitute industry
- Exit the niche if it is at the end of its life cycle

In summary, all of life is an evolution. Business is no different. Products, services, needs and markets change and evolve. As new technologies, products, processes and uses are developed and disseminated, competitive positions wax and wane. Every business owners must embrace change and harness change to his or her advantage. One does so by monitoring trends, searching for new ways to serve clients, and being open to new uses for the products and competencies that one possesses. One also watches for competitive threats and then fashions a response that makes strategic and economic sense. □

This article is the seventh and last in a series that has presented the state of the art in competitive theory. The series was based on the work by a Michael E. Porter. His two primary works are books titled Competitive Strategy and Competitive Advantage.

- Part 1: *Introduction to Competitive Strategy and Competitive Advantage (2002 Nov/Dec issue)*
- Part 2: *Industry Structure and The Five Competitive Forces that Influence Industry Profitability (2003 Jan/Feb issue)*
- Part 3: *How to Pursue Differentiation as a Path for Superior Profits Advantage (2003 Mar/Apr Issue)*
- Part 4: *Cost Drivers and Where to Look to Lower Cost (2003 May/June issue)*
- Part 5: *Customer Perception and Signaling (2003 July/Aug issue)*
- Part 6: *Buyer Value and The Value Chain (2003 Sept/Oct issue)*
- >Part 7: *Substitution, Switching and Switching Costs (This issue of The Business Owner)*

2003 Tax Information of Interest

(Revised For Tax Law Changes Enacted May 28, 2003)

PERSONAL EXEMPTION	\$3,050 per person (none if filing as a dependent), \$14,000 if 50 or older
EXCEPTION PHASEOUT	Starts at \$209,250 MFJ, \$104,625 MFS, \$139,500 S, \$174,700 H of H
MAXIMUM SALARY DEFERRALS	\$12,000 for 401(k), 403(b), 501(c), 457 plans, \$14,000 if 50 or older; \$8,000 for SIMPLE, \$9,000 if 50 or older
MAXIMUM IRA CONTRIBUTION	\$3,000 (Regular or Roth), \$3,500 if age 50 or over
STANDARD MILEAGE RATES	Business: 36¢ Charity: 14¢ Medical/Moving: 12¢
ITEMIZED DEDUCTION PHASEOUT	Starts at AGI over \$139,200 (MFJ, H of H), \$69,600 (single)
SOCIAL SECURITY	Under 65, can earn up to \$11,280 without repaying benefits. Over 65, no limit. Earnings subject to SS tax: Employee: \$87,000 (maximum \$5,394.00) Household Help: cash wages over \$1,300
KIDDIE TAX (Children under 14)	First \$750 not taxed; \$750-\$1,400 at child's rate; over \$1,400 at parent's rate.
FOREIGN INCOME EXCLUSION	\$80,000
SECTION 179 LIMIT	Limit on immediate deduction for assets being placed in service: \$100,000
CAPITAL GAINS RATES*	Assets held 1 year or less: taxed at ordinary income rates Assets held more than 1 year: • 15% for taxpayers in brackets higher than 15% (20% if sale occurred before May 6) • 5% for taxpayers in 15% or lower tax bracket (10% if sale occurred before May 6)
*Non-collectables	
CHILD TAX CREDIT	\$1,000 (phaseout begins at AGI of \$110,000 MFJ, \$55,000 MFS; \$75,000 SGL, HH, QW)
BUSINESS DEPRECIATION "BONUS"	50% (25% if purchased before May 6)
MARRIAGE CREDIT	\$1,000
AMT EXEMPTION	\$58,000 MFJ; \$42,250 S
DIVIDEND INCOME	5% for 10% and 15% income tax rate payers 15% for taxpayers in brackets higher than 15%

ESTATES AND TRUSTS

If Taxable Income Is:	The Tax Is:
Not Over \$1,900	15% of the taxable income
Over \$1,900 but not over \$4,500	\$285 plus 25% of excess over \$1,900
Over \$4,500 but not over \$6,850	\$935 plus 28% of the excess over \$4,500
Over \$6,850 but not over \$9,350	\$1,593 plus 33% of the excess over \$6,850
Over \$9,350	\$2,418 plus 35% of the excess over \$9,350

MARRIED FILING JOINT/SURVIVING SPOUSE

If Taxable Income Is:	The Tax Is:
Not Over \$14,000	10% of the taxable income
Over \$14,000 but not over \$56,800	\$14,000 plus 15% of excess over \$14,000
Over \$56,800 but not over \$114,650	\$7,820 plus 25% of the excess over \$56,800
Over \$114,650 but not over \$174,700	\$22,282.50 plus 28% of the excess over \$114,650
Over \$174,700 but not over \$311,950	\$39,096.50 plus 33% of the excess over \$174,700
Over \$311,950	\$84,389 plus 35% of the excess over \$311,950

* Standard deduction: \$9,500 (+\$950 if age 65+ or blind; +\$950 for each spouse over 64)
* IRA Contribution phaseout: \$150,000-\$160,000

HEAD OF HOUSEHOLD

If Taxable Income Is:	The Tax Is:
Not Over \$10,000	10% of the taxable income
Over \$10,000 but not over \$38,050	\$1,000 plus 15% of excess over \$10,000
Over \$38,050 but not over \$98,250	\$5,207.50 plus 25% of the excess over \$38,050
Over \$98,250 but not over \$159,100	\$20,257.50 plus 28% of the excess over \$98,250
Over \$159,100 but not over \$311,950	\$37,295.50 plus 33% of the excess over \$159,100
Over \$311,950	\$87,736 plus 35% of the excess over \$311,950

* Standard deduction: \$7,000 (+\$1,150 if age 65+ or blind)
* IRA Contribution phaseout: NONE

SINGLE

If Taxable Income Is:	The Tax Is:
Not Over \$7,000	10% of the taxable income
Over \$7,000 but not over \$28,400	\$700 plus 15% of excess over \$6,000
Over \$28,400 but not over \$68,800	\$3,910 plus 25% of the excess over \$28,400
Over \$68,800 but not over \$143,500	\$14,010 plus 28% of the excess over \$68,800
Over \$143,500 but not over \$311,950	\$34,926 plus 33% of the excess over \$143,500
Over \$311,950	\$90,514.50 plus 35% of the excess over \$311,950

* Standard deduction: \$4,750 (+\$1,150 if age 65+ or blind)
* IRA Contribution phaseout: NONE

MARRIED FILING SEPARATE RETURNS

If Taxable Income Is:	The Tax Is:
Not Over \$7,000	10% of the taxable income
Over \$7,000 but not over \$28,400	\$700 plus 15% of excess over \$6,000
Over \$28,400 but not over \$57,325	\$3,910 plus 25% of the excess over \$23,725
Over \$57,325 but not over \$87,350	\$11,141.25 plus 28% of the excess over \$57,325
Over \$87,350 but not over \$155,975	\$19,548.25 plus 33% of the excess over \$87,350
Over \$155,975	\$42,194.50 plus 35% of the excess over \$155,975

* Standard deduction: \$4,750 (+\$950 if age 65+ or blind) (SD)
* IRA Contribution phaseout: \$0-\$10,000
Note: Standard deduction (SD) for dependents is the greater of \$750 or earned income plus \$250 (not to exceed the SD for dependent's filing status)

IQ is Necessary but Not Sufficient

(The Hard Side of Soft Skills)

It was a six-figure mistake! Despite expressed concerns, Devin Kingmen was promoted to president.

Ten years earlier, Devin graduated from college at the top of his class. He was hired to support accounting and handle purchasing. Over the years, he endeared himself to the company owner, Gary Jackson, for his loyalty and unyielding support.

In recent years, Mr. Jackson has sought more balance in his life. To achieve this, he decided to delegate the day-to-day management of the business to another. Devin was the owner's first choice.

However, at the urging of Mr. Jackson's banker, a specialist was hired to assess Devin's suitability for management. The results certainly supported what was already apparent. Devin was loyal and intelligent. However, weak communication and interpersonal skills including aloofness, fear of conflict and an abrupt style were also revealed. It was also found that Devin was perceived poorly by his peers. A common theme was that they saw him as a "yes man" to the owner.

Despite the warnings, Mr. Jackson "went with his gut," as he usually did. His friendship with Devin, partially developed by weekend fishing and hunting trips, won the day. However, chaos and infighting ensued almost immediately. Productivity fell sharply. Nine months later, the top two salesmen resigned. Then, the finance manager quit and a longtime customer defected to a competitor.

The bottom line? The company swung from profit to loss and the future was suddenly uncertain. Despite his best intentions, Mr. Jackson had more work on his hands than ever.

How could this happen by promoting a longtime, loyal and intelligent employee? The answer is that while Devin clearly had sufficient IQ and a knack for knowing 'where his bread is buttered,' he was woefully inadequate in what some are referring to as EQ.

IQ or intelligence quotient, is that conglomeration of logic, reason and analytical skills to which we often refer. IQ has Einstein as its poster boy. But, recent research shows that IQ is not a good indicator of ability to effectively lead people, execute a results-driven business plan and achieve goals through working with others. The bottom line is that IQ is now, more than ever, being

relegated to what is referred to as "threshold" ability - meaning that it is necessary, but not sufficient.

IQ is not enough to enable strong managerial performance. A set of skills referred to as EQ, or emotional IQ, is necessary as well. We somehow know this intuitively, as business owners, but research is now proving this out. Research is also giving us tools that can help us, and those that work for us, develop and improve essential EQ skills.

More than simply a theory of human performance, it has very practical implications for us as business owners. EQ refers to *a person's ability to recognize and regulate his or her own emotions, and those of others*. The idea is that the most effective leaders in your company will have two sets of "competencies" - personal and social. *Personal competencies* include self-awareness, self-regulation, self-management and self-motivation. *Social competencies* include social skills, empathy and interpersonal awareness. Together, these abilities will often make the difference between a top performer and one that is mediocre - or even a liability to your company.

Research in the area of emotional intelligence, referred to as either EQ or EI, was pioneered in the early 1990's by two American University professors, John Mayer and Peter Salovey. A Daniel Goleman has advanced the research greatly in its application to companies, employees and management performance. Mr. Goleman's website is www.ei.haygroup.com. Another useful website is www.EQ.org. □

Jay Kent-Ferarro, Ph.D. contributed materially to this article. Dr. Kent-Ferarro, through his consulting firm Empowerment Technologies, provides executive coaching, training and human performance consultation. He can be reached at 918-744-7025.

**"On matters of taste, swim with the current.
On matters of principal, stand like a rock."**

Thomas Jefferson

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