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CLIENT'S tax & financial UPDATE
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A tax, business, and financial planning newsletter for our clients and friends

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A Better Way To Handle Merit Pay Increases

Although merit pay increases are important to a healthy business, they present pitfalls which some employers don't recognize. One drawback to merit increases is that they increase an employee's salary for as long as the worker remains with the company; once you've given a merit raise, it's very difficult to take it away. Furthermore, merit raises also increase certain benefit costs which are usually tied to salaries.

Merit increases can create other problems, too. They can often be risky because it's difficult to raise prices to offset higher payroll costs. And if merit raises aren't given consistently to all deserving personnel, they can actually lower employee morale.

How to make merit raises work

The first rule is to give merit raises only to employees whose performance is obviously outstanding. Other workers should be rewarded with bonuses, which are not a recurring expense and don't affect the cost of benefits.

To limit merit raises only to truly deserving employees, you must identify the jobs which are really vital to the company. You must then quantify the critical aspects of those jobs so you can give merit increases to the workers who excel in those aspects and who, in your judgement, are dedicated to the well being of the company.

The first step is to break each job down to specific tasks. Next, measurable standards of performance must be set for each task. Once this has been done, an importance rating must be assigned to each task. This is necessary because an employee

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taxPOINTS

Loophole: Reallocate income or loss among your partners. A general partnership can change each year how it allocates income or losses to its partners. All that is needed is to make a change to your partnership agreement.

Worthless securities. Sell worthless securities and investments by year-end to get a capital loss in 2018 for their loss in value.

Early withdrawals. Penalties incurred on early withdrawals from time deposits and certificates of deposits are deductible. If you are planning shortly to make such a withdrawal doing so before year-end will accelerate the penalty deductions into 2018.

Pitfall: Transferring money from a company pension plan to an IRA. Transfers to an IRA must be completed within 60 days to avoid tax. If more than 60 days pass before the transfer, the entire amount is taxable as income, and if you are not age 59 1/2, there is an additional 10% penalty.

Social Security Tax Exemptions

The maximum income from salaries and wages which is subject to Social Security tax keeps going up. For 2018, many taxpayers will pay more Social Security tax than ever before.

There are, however, several kinds of payment which are not subject to Social Security tax. Here are some examples.

- Social Security benefits payments are exempt from Social Security tax, although they may be subject to income tax depending on your total income.
- Company loans to a stockholder or an employee are not subject to Social Security tax, but documentation showing that the loan will be repaid must be available. If the IRS decides that the loan will not be repaid, it can impose Social Security tax on the amount borrowed.
- Wages you pay to your under-age-18 children are also exempt from Social Security tax, but only if your business is a sole proprietorship. If your business is a corporation, all wages are subject to Social Security tax.
- Fringe benefits are not subject to Social Security tax. Typical examples of exempt fringe benefits include employer-paid health insurance premiums and employer contributions to qualified retirement plans.
- Payments received that are not compensation for services rendered are exempt from the tax. Such payments include interest, dividends, rents, pensions, inheritances, and gifts.

Charitable Deductions

To claim a charitable deduction you must make donations by year-end and obtain necessary documentation to support them. This documentation can be:

- An acknowledgement letter from the charitable recipient for all gifts larger than $250. A canceled check is not enough.
- An appraisal for any donated property valued at over $5,000.

Plan For Tax Savings When You Set Up A Family Business

Family-owned businesses can offer an opportunity for considerable tax savings. Not only can you opt for a corporation, a proprietorship, or a partnership, but you can also combine the various forms of ownership to your advantage.

If you organize the business as a partnership or Subchapter S corporation, for instance, early business losses can be passed through to owners in high tax brackets. When the business begins to show a profit, title or stock can be transferred to younger family members who are in lower tax brackets.

If the business is organized as a corporation, its real estate, machinery, or equipment can be owned by an individual and leased to the company. Rental income will pass directly to the owners without being subject to corporate tax. Ownership of these major assets can also be placed in trust for the benefit of the owners' children to take advantage of income splitting.

Obviously, the business structure that most benefits one family will not necessarily suit another. In addition, the tax law restricts the deductibility of certain family-owned business losses. So be sure to consult with your tax professional before you choose a structure for a family business.

Save Estate Taxes With Year-End Gifts

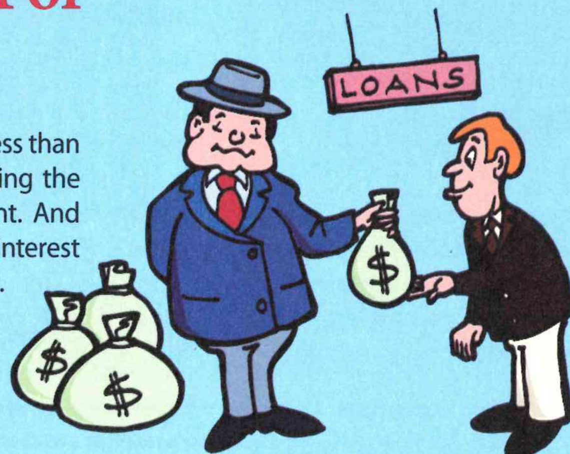
If your assets are substantial, making year-end gifts to your children can reduce the value of your taxable estate. Here are some guidelines for a gift-giving program.

- There are maximum annual amounts which are free from the federal gift tax. For unmarried donors, the upper figure is $15,000 annually. Married donors can make an annual combined gift of up to $30,000.
- Gifts that exceed the maximum limit, but are made as direct payment for tuition or medical bills, can be tax-free.
- If you prefer not to make large gifts to younger children, there are several alternatives available, including certain trusts and custodial accounts. Consult with your accountant to find out which is best for you.

When It Pays To Borrow For Estimated Tax Payments

If you file estimated tax returns, you may occasionally find yourself short of the cash needed to make a payment and face an IRS penalty for late payment.

Rather than missing a payment, consider borrowing enough to make the payment. The interest you'll pay on the money you borrow will probably be less than the penalty for not meeting the estimated tax requirement. And some part of the loan interest may be deductible as well.



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A Better Way To Handle Merit Pay Increases (continued)

might be doing everything extremely well except for the most important aspect of the job. Obviously such an employee doesn't deserve a merit increase as much as another worker who performs important tasks exceptionally well and less important tasks not quite as well.

As an example of how this plan can work, here's a rating system that might be applied to a data entry clerk. Note how this job is broken down into four separate tasks and how each task is given a performance rating.

- Entering 200 records a day is the most important aspect of this job and is rated at 60%.
- Entering data at a 95% accuracy rate is less important and is rated at 20%.
- Checking the daily work of a co-worker is even less important and is rated at 10%.
- Training new workers is also less important and is rated at 10%.

Now let's assume that the employee

must have an overall rating of 90% to be eligible for a merit raise. If the worker averages 240 entries a day (20% more than expected), the employee's rating for that task is 72%. If the worker's data entry accuracy is 85% (less than the expected 95%), the worker gets a zero rating for that task. If the worker performs at the expected level for each of the last two tasks, another 20% is earned. This would give the clerk a total rating of 92%, which qualifies for a merit increase.

For this system to work, the ratings must be based on performance for

an entire year. Supervisors must evaluate and record an employee's performance rating each month. In addition, the rating system must be clearly explained to employees. When employees understand how they are being rated, the system will motivate them to achieve the ratings that will earn them merit increases. If the rating system isn't clear, it will have little or no effect on employees motivation.

How to use bonuses

One of the biggest drawbacks to merit pay increases is that supervisors may tend to inflate employee ratings regardless of actual performance. This can qualify too many employees for merit increases and cause payroll costs to increase rapidly. To avoid this problem, determine a fixed amount which can be spent on increased compensation. Then distribute that amount based on performance, making certain that only the best employees get a maximum increase.

Even worse, if a company has a poor year, it's almost impossible to reduce salaries accordingly. For example, over a ten-year period, compensation costs might rise 60% while sales might increase by only 12% because there were no pay reductions in the years when sales were down.

Controlling steadily increasing payroll costs is best handled by bonuses to exceptional workers. The same rating system used for merit raises can be used to determine which employees get bonuses. However, don't make bonuses automatic. Instead, establish overall company goals that must be met before employees can be eligible for bonuses.

Because bonuses are a non-recurring expense, they are particularly attractive to companies where sales fluctuate from year to year or where sales are difficult to forecast. In addition, bonuses motivate workers who might not be eligible for merit raises because they have reached their maximum salary level.