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TAX LETTER
Spending to Save Income Tax

Real wealth is accumulated with after tax money. Effort to lower your taxes also lowers your ability to create wealth. One of the best indicators of wealth creation may just be "How much is your taxable income, thus how much income tax do you pay ?" If you are making good money or running a successful business and only pay very little income taxes, you may be either cheating or spending too much to reduce your income taxes.

Let's assume that you are a cash base, sole proprietor and your marginal tax rates is 35%. During "so call" year end tax planning, you may be cautious enough and not fall into the traps of elaborated tax saving schemes, but you may be attracted by standard tax saving methods. Regardless, you can only save 35 cents on every dollar you spend to save it.

In order to save 35 cents on the dollar, you may (1) decide to pay off your vendors sooner than required before the year end to accelerate the deductions; or (2) decide to buy business equipments which you think you may need them in the future for the purposes of "bonus depreciation" and/or section 179 write-off, etc. To do that, you either spend a lot of your cash before the end of the year or incurred substantial amount of additional debt to finance the pay-off and equipment purchase. Either way, you created problem for your business. At this point, you may want to ask "why". The reasons are as follows:

Firstly, for most growing business, there are needs to maintain business lines of credit with sufficiently high limit. Also, business involving certain contracts may be required to be bonded. In general, both the credit lines and the bonding need to be annually renewed. In order to renew and perhaps to increase the amount of credit lines and bonds, presentation of reasonably good Annual Financial Statements to banks and bonding insurance companies are essential.

If cash is used to accelerate deductions and/or buying equipments, the business's cash will be depleted and the cash position of the Company will be much weaker. If additional debt is used to achieve the tax saving objective, the Company's debt to equity ratio will be negatively impacted. Either way, it is harmful to the financial position of the Company and to the chances for increased credit limit and/or bond limit. As a result, the ability to grow or expand the Company will be limited.

Secondly, opportunity does not knock twice, it comes and it goes. Because substantial cash outflow or significant borrowing increase at the end of prior year, the Company will most likely unable to take the advantage of a good opportunity knocking at their door sometime during the following year.

Thirdly, the "so call" tax savings are not genuine savings, they are for most part tax deferrals. Accelerating payments before they are due for immediate deductions and spending on equipments before they are needed for current write-off are actions to defer taxes, not to save taxes. Sooner or later, the Company will have to pay back all the deferred taxes. How can someone grow and expand a business and in turn creating wealth, by just DEFERRING the inevitable and by so doing missing all possible opportunities.

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