

## COMMENTS - APRIL, 2004

### ACCOUNTING AND AUDITING

- Early in 2003, the Financial Accounting Standards Board was considering dropping a major overhaul of its pension accounting rules in favor of new disclosure requirements for defined benefit plans which would have been effective for fiscal years ending after December 15, 2003. However, it has now reversed course and says companies with traditional retirement plans can continue reporting annual changes in the balances of plan assets and liabilities using the format which has been in existence for over a decade. The reversal stems from objections raised by retirement plan sponsors, actuaries, analysts and other pension experts to the new disclosure proposals. However, the FASB is continuing its deliberations about a major overhaul in pension plan reporting and disclosure requirements and hopes to issue a pronouncement shortly.
- Accounting is often thought of as a dreary subject which does little for the imagination or the creative spirit of mankind. Therefore, it might surprise you to know there is much evidence that the need for accounting may have been the catalyst for the development of written language. Scholars believe writing originated in Mesopotamia as a method of bookkeeping. The earliest known texts, discovered in the city of Uruk and comprised hundreds of thousands of cuneiform blocks containing lists of livestock and agricultural implements which date back to 3100 B.C., are believed to have been accumulated for tax purposes. Similar discoveries made at various excavation sites along the Tigris and Euphrates rivers also revealed credit receipts and monetary contracts which suggest accounting, banking and credit operations were everyday affairs throughout Babylonia. More concrete evidence of accounting and credit transactions can also be found in the Code of Hamurabi on display at the Louvre. The seven foot high block on which it is inscribed dates back 3,750 years and contains rules for credit and banking transactions and their accounting.
- Cost accounting is a system for accumulating material, labor and overhead, the three elements of cost, and allocating them to specific jobs or products in a manufacturing environment. In general, direct material and direct labor costs are accumulated as they are incurred in production while indirect material, labor and overhead costs are applied to the product on the basis of pre-determined formulas intended to apportion these costs in a rational manner. The objectives of cost accounting systems are to provide:
  - < Reliable data for production and financial planning which can be incorporated into budgets.
  - < Accounting controls over operations by means of comparisons of predetermined (budgeted or standard) costs with actual costs.
  - < A meaningful basis for estimating costs as an aid for bidding on jobs and contracts.

Cost accounting systems may be designed to accumulate information by cost centers, department, process, operation or some other logical sub-division of the production process. Furthermore, similar systems can also be developed for planning and control over non-manufacturing costs such as shipping or marketing. Technological changes in the production process, enhancements in computer technology and development of increasingly sophisticated software have led to the rapid obsolescence of cost accounting systems and the need for frequent review of existing systems and regular upgrading.

## **ADMINISTRATION, SYSTEMS AND EDP**

- Although the power blackout in the Northeast last summer should have been a warning for business managers to insure they had adequate disaster recovery systems in place, surveys suggest the majority of businesses are still unprepared. For example, in one survey:
  - < 55% indicated the firm had no backup facilities at another site.
  - < 45% were not conducting emergency situation drills.
  - < 44% lacked back-up files in a distant locale.
  - < 41% had failed to enhance fire walls to protect against hacker attacks.
  - < 40% had not improved security background screenings of potential new hirees.
  - < 34% had not tightened access to their facilities.
  - < 22% were still not backing up computer files and documents.

The survey was conducted by Guardsmark LLC, a security service firm and encompassed security professionals at 203 firms. Another fact was that about 50% of businesses have not increased their disaster recovery budgets as a result of last summer's blackout.

- Business fraud and similar financial abuses within the organization cost small companies an estimated \$127,500 per incident, according to the Association of Certified Fraud Examiners. Therefore, it's important to know how companies obtain information about fraud within their firm. According to the ACFE, the main sources are:
  - < Employee tips - 26%
  - < Accidental discovery -18%
  - < Internal audits -18%
  - < Internal control detection - 15%

Other likely sources include information from suppliers or customers. This is frequently obtained in connection with accounts receivable and accounts payable confirmation procedures on independent audits.

- Back in 1995, the IRS issued a notice raising the threshold for retaining documentary evidence with respect to a variety of business travel expenses from \$25 to \$75. Recently, the IRS clarified that while the \$75 threshold allows a taxpayer to forego retaining receipts to document a lesser expenditure, it does not excuse the taxpayer

from maintaining adequate records to substantiate the expenditure. Thus, the taxpayer is still required to maintain a contemporaneous account book, diary, log or similar record to substantiate the amount, time, place and business purpose of an expense for which a documentary receipt may not be required. Incidentally, the IRS also clarified that taxpayers on ships in international waters may use a per diem rate of \$43 per day for lodging, meals and incidental expenses instead of actual expenses, to substantiate business travel expenses.

- Given the tough business conditions in many industries, business managers are focusing on ideas for customer retention and cost savings. According to one recent survey, these were the primary priorities listed by respondents:
  - < Improving customer service
  - < Understanding and meeting customer needs
  - < Tightening web site security to protect customer privacy
  - < Enhancement of offerings to boost business value
  - < Simplification of business processes
  - < Improving worker productivity
  - < Increasing the return on capital investment

## **FEDERAL REGULATIONS**

- The recently enacted Medicare prescription drug legislation contains sweeteners for many businesses. For example:
  - < Employers providing prescription drug coverage for retirees can obtain tax free prescription drug reimbursements of up to \$1,330 per employee if they don't drop the coverage in 2006, when the next Medicare plan is initiated.
  - < Managed care firms gain incentives for treating elderly patients under Medicare+Choice in the form of larger reimbursements, beginning in 2004.
  - < Brand name drug manufacturers will have increased sales to seniors because of the prescription drug coverage contained in the legislation.
  - < Generic drug manufacturers will be able to get their drugs to the marketplace on an accelerated basis.
  - < Physicians will receive 1.5% increases in Medicare reimbursement rates in 2004 and 2005 instead of cuts that had been scheduled.
  - < Pharmacy benefit managers will earn fees on discount drug cards seniors will use until the Medicare benefit takes effect in 2006.
  - < Rural hospitals and doctors will receive \$25 billion in Federal funds over 10 years to offer improved service at more affordable prices.
- The Securities Exchange Commission has issued new rules requiring corporations to provide shareholders with improved information on how to communicate with

corporate boards. The rules require:

- < Companies to inform shareholders whether directors are independent of the company and describe how the board handles nominations to the board in the proxy materials provided before the annual meeting.
- < Nominating committees to inform shareholders anytime they reject a candidate recommended by shareholders holding at least 5% of the company stock.

An earlier rule requiring boards to explain why they turned down a prospect has been scrapped because it was feared it might impede frank discussions within boardrooms. The new rules are effective 30 days after publication in the Federal Register.

## **INSURANCE**

- Want to reduce your homeowners' insurance costs? Here are some ideas which may help:
  - < Try to obtain a discount if you are retired and over 55 years old. Some insurers believe this group takes better care of property because they spend more time at home.
  - < If your house is constructed of fire resistant brick or concrete, or has a fire resistant roof, you may be eligible for a premium discount.
  - < Maintain a high credit score since insurers frequently charge higher premiums to people with a low credit score.
  - < Evaluate your ability to self-insure and utilize higher deductibles.

Needless to say, avoid small claims since they will not only cause your premiums to rise, but could also result in cancellation of your policy when it comes up for renewal.

- Final IRS regulations will make split-dollar insurance a lot more taxing for executives, and are likely to eliminate this kind of insurance as an effective tax strategy. The IRS regulations indicate, if the employee owns the policy, employer paid premiums that are to be repaid are treated as loans and subject to taxation under the imputed interest rules. Conversely, if the premiums do not need to be repaid, they are treated as income to the covered executive. If the employer is the owner of the policy, the value of the insurance coverage is taxed to the employee, and if the employee is given equity in the policy, he or she is also subject to tax on the increase in value of that equity interest. The regulations apply to policies entered into after September 17, 2003, and to older policies materially modified after that date. Employees with an equity split-dollar policy are taxed on old policies if they were terminated after September 17, 2003. However, the equity interest will escape tax if a policy that was issued before January 28, 2002, was terminated by the end of 2003.
- Do you employ a nannie, housekeeper or elder-care attendant? You might want to

provide some basic health insurance for the person. Possibilities include:

- < Obtaining an individual policy for this type of domestic worker. Premiums range from \$50 per month for emergency hospital coverage to \$300 per month for full medical coverage.
- < Obtaining business association insurance, group insurance, which costs between \$200 and \$300 per month for full health coverage or HMO coverage.
- < Getting short-term coverage which lasts a half year. Here premiums are usually under \$100 per month, but the insured must satisfy a deductible and the policy pays 80% of the next \$5,000 in expenses and 100% thereafter up to a cap of \$1 million.
- < Purchasing a discount card for a monthly fee of \$10 to \$50. The cards provide a drug discount at participating pharmacies and may also provide discounts for vision and dental care. Providers also charge a \$5 enrollment fee.

## **LABOR RELATIONS**

- The IRS has clarified that an employer's expense reimbursement arrangement which uses electronic receipts as substantiation for deductible travel and entertainment expenses may qualify as an "accountable plan" under the Internal Revenue Code. It says the electronic reporting method is acceptable as long as it satisfies the business connection, substantiation and return of excess advances requirements. According to the IRS, if an arrangement does not meet one of these requirements, all amounts paid to the employee are deemed paid under a "non-accountable plan" and must be included in the employee's gross income, reported on the employee's W-2 form and are subject to withholding and payment of employment taxes. Here, the employee can only deduct properly substantiated expenses as itemized deductions to the extent they exceed 2% of adjusted gross income. Ongoing changes in technology make it advisable to review accountable travel and entertainment expense reimbursement arrangements on a regular basis to assure that they are in compliance with IRS requirements.
- One way to attract, motivate, reward and retain key employees is to provide fringe benefits based on the company's stock. Possibilities include:
  - < Giving stock and cash, to cover taxes, outright to the employee as additional compensation.
  - < Utilizing a Section 83(b) election to minimize taxes on the eventual sale of stock. Here an election has to be made within 30 days after receiving an option or restricted stock, enabling the executive to establish a low basis for the stock. With respect to stock and non-qualified options (NQSO), the election applies to the value of the stock when it was received. The employee is taxed when receiving the stock or NQSO on the difference between the fair market value of the shares at the point of the receipt and the price paid, if any.

- < Utilizing restricted stock, to give the employee the benefit of stock ownership without the company providing immediate stock ownership. Here the stock vests in installments over a specified period of time.
- < Providing an incentive stock option. Here, if the option price equals or exceeds the stock's fair market value at the time of grant and if the market value of the stock subject to option does not exceed \$100,000 per year at the time of grant, the options are not taxed when issued or granted to the executive. Furthermore, gains from the sale of stock held over 1 year after an ISO is exercised, and over 2 years after the ISO is granted are taxed at favorable capital gains tax rates.
- < Using non-qualified stock options. These do not carry the conditions or limitations of incentive stock options, but are taxed as compensation income when exercised based on the difference between the stock's value and the option price.
- < Issuing "phantom stock" to the executive. Here units corresponding to shares of stock are assigned to the executive, and the effect is the same as if stock or options were exercised, except no stock changes hands. From a tax standpoint, however, income tax is paid at ordinary income tax rates when cash changes hands, and there is no capital gain benefit.
- According to Robert Half, executive perks are rapidly disappearing. Based on responses from chief financial officers at 1,400 firms with over 20 employees, here, in order of frequency, are the perks that are vanishing most rapidly:
  - < Company cars
  - < Country club memberships
  - < Stock options
  - < Signing bonuses
  - < Performance bonuses
  - < Extra vacation days.

Undoubtedly employer attitudes are being impacted by revelations of outrageous compensation arrangements of executives who in some instances succeeded in bankrupting their companies.

## **MARKETING**

- Do you accept purchase orders from customers via the phone? When the price, quantity and terms of sale are given verbally, there is a good chance errors can arise which will ultimately lead to costly disputes, and even loss of the customer. Therefore, we recommend verbal orders only be accepted for small rush orders as an accommodation to the customer, and a written purchase order be required for all orders above a nominal amount. If the customer is made aware, there is mutual benefit to your policy and you're unlikely to meet resistance.
- Some business owners are happy not to hear from customers. They think lack of complaints is an indication customers are satisfied. But that may be an entirely

erroneous viewpoint. The absence of customer feedback can also mean customers have given up on the company and are giving their business to someone else. Business consultants generally believe customer feedback should be encouraged and firms should establish a special e-mail address where customers can air their gripes. It's also a good idea to conduct telephone or mail surveys on a regular basis to assess customer attitudes towards your firm and obtain information about unsatisfactory practices or policies. Some firms even train sales personnel to be alert to customer dissatisfactions and report them to management.

## **MONEY, BANKING AND CREDIT**

- Many lenders are marketing so-called "interest only" mortgages to home buyers. They are designed to increase the buying power of home purchasers as housing prices rise. Typically, these mortgages require payment of interest only, during the initial years of the mortgage, and delay principal payments. We want to caution readers about the risks. Once the principal payments have begun, the total payment can rise dramatically since the principal has to be paid off over a shorter period than with a standard mortgage. Thus, these mortgages may be suitable for people who are refinancing, who have considerable other assets or who are not intending to stay in the home for long. People who have great difficulty in making the standard mortgage payments should definitely not opt for one of these "interest only" mortgages, but look for a less costly property.
- If you are going to finance the purchase of a car, you may be able to negotiate the interest rate on the loan. Here, is what usually happens. When you take out the loan, the dealer sends your credit history to a lender. The lender informs the dealer what interest rate you are entitled to based on your credit history. The dealer marks up the rate (5 percentage points is not unusual) and quotes you the interest rate on the loan. Since the rate has already been inflated, it is often possible to bargain for a lower rate. Alternatively, if you have a good credit history, a bank, credit union or another lender may offer you better terms.
- Are your customers complying with your invoice terms with regard to taking discounts and making timely payments? According to a survey of 350 financial executives by Professional Business Publications, 43% indicated more than 75% of customers abided by the invoice terms. In turn, 57% of the executives indicated fewer than three-fourths of customers adhered to the terms. It's important to analyze payment patterns to identify customers that continually violate sales terms, since this has a direct impact on profitability.
- Whenever you extend credit, there is the possibility a customer will be unable to, or will refuse to pay the debt. However, some simple practices will enhance your chance of collecting. Here are some ideas:
  - < Secure an interest in the goods or services you provide by perfecting a purchase money security interest under the Uniform Commercial Code in the state where the debtor is located.
  - < Include a subordination agreement in the contract with the debtor, requiring the

customer to pay your debt ahead of all other debt.

- < Submit a written reclamation notice to the customer for return of the goods if unforeseen circumstances threaten recovery. The Uniform Commercial Code gives you 10 days from the date of delivery in these circumstances to take back the goods.
- < Obtain personal guarantees from the debtor, together with a pledge of tangible assets you can seize.
- Unless you are the CEO or CFO of one of the very large companies, you, as the owner of a small or mid-size business should personally sign all of the checks. There are a variety of reasons for this advice, including:
  - < Enabling you to have an overview of where the money is going.
  - < Allowing you to observe frivolous spending anywhere in your organization.
  - < Deterring possible fraud, since employees know management sees all of the checks.

Personal review and signing of checks by the owner is the most effective internal control for any small business.

## **PENSION AND ESTATE PLANNING**

- The IRS has just provided tax filing relief for U.S. residents with Canadian retirement plans. The Agency has indicated Forms 3520 and 3520-A need not be filed by these individuals for 2003, since it is in the process of developing a new simplified form they can use to defer any income tax and report their ownership of Canadian registered retirement savings plans and investment funds. The IRS intends to have the new form available in time for the tax filing season. In the event there is a delay, the IRS notice provides the appropriate reporting requirements.
- One of the principal benefits of 401(k) accounts and other qualified retirement plans is they are protected by Federal law even if a person files for bankruptcy or has a civil court judgment against him or her. (The protection does not extend however, to a divorce or a tax judgment.) Conversely, there is no Federal protection for non-qualified retirement plans. Thus, the protection is determined under state law, and may be less than under Federal law. It's important to know to what extent your retirement plans may be protected from creditors and other claimants.
- It's not uncommon for a deceased person to leave a single IRA which names several beneficiaries. This creates a problem because each beneficiary may want to take control over managing his or her share of the account. According to the IRS, the institution holding the IRA account may divide it into two or more separate accounts, one for each of the beneficiaries, without adverse tax consequences. However, taxpayers must make sure the IRAs continue to be titled in the deceased IRA owner's name or the lump sum in each account becomes taxable to the beneficiaries immediately. As long as the deceased's name and the beneficiary designation remains on the account, the distributions may be taken over the life expectancy of



each of the beneficiaries, allowing for continued tax deferral of the undistributed assets and earnings in the account.

- Some people have decided to forego estate planning since they assume the estate tax will be repealed in 2010. We believe this is a serious mistake, for the following reasons:
  - < The tax provisions calling for repeal, provide only for a 1 year repeal, so the tax would return in 2011. Thus, for the estate to be protected, the taxpayer would have to die in 2010.
  - < The return of immense budget deficits increases the government's need for revenue, making it extremely unlikely the repeal will ever occur.
  - < Even in the event of repeal, the tax would likely be reincarnated by Congress in some other form, as on three prior occasions.

We believe uncertainty about the future of the estate tax makes estate planning more, not less, important than before, since a variety of possibilities now have to be considered. It's also important for those who have already developed an estate plan to seek a professional review to be sure it's properly updated as tax law changes occur.

- The annual gift tax exclusion lets you transfer \$11,000 (\$22,000 jointly with a spouse) to as many recipients as you desire each year free of gift tax. However, it's possible to enhance the transfer significantly by leveraging it with life insurance. For example, if the gifts are made to children or grandchildren and are used by them to pay the premiums on life insurance policies on your life, but with the gift recipient as beneficiaries, the life insurance proceeds will eventually go to the beneficiaries and be received by them free of income tax. Furthermore, the proceeds could also escape estate tax if the policy is owned by an appropriate life insurance trust. Of course, it's necessary to determine the cost of the insurance until the policy is self-financing (increases in cash surrender value equal the premium cost) and compare it with the proceeds to determine whether this type of strategy can be effective in transferring significant amounts of wealth from an estate.

## **PERSONAL FINANCIAL PLANNING**

- Cell phones are considered "listed property" for tax purposes, and are subject to strict substantiation requirements for deductions to be allowed. Thus, to corroborate the business use of the phone you should maintain a written record containing:
  - < The amount of the expense
  - < The time and place of the expense
  - < The business purpose of the expense
  - < The business relationship to the taxpayer of the person involved in the expense

The IRS has denied taxpayer deductions for business use of a cell phone where

taxpayers have failed to maintain an adequate record for substantiating the expenses claimed. The IRS is particularly watchful in situations where a business makes only a marginal profit and business cell phone use represents a significant expense.

- College costs are on the rise again, with tuition increases up 14.1% for the 2003-2004 academic year. Average tuition and fees are now \$4,694 at public four-year institutions and \$19,710 at private institutions. Add on room and board and the figures go up respectively, to \$10,636 and \$26,854. Surprisingly, despite these significant costs, a recent survey by Harris Interactive, a market research firm, indicates 64% of parents and 65% of grandparents are unfamiliar with Section 529 college savings plans and only 14% of families are currently investing or intending to invest in these income and estate tax favored vehicles for accumulating a college fund for children or grandchildren.
- Even if you are receiving dividends from foreign corporations, you may qualify for the reduced rates provided by the Jobs and Growth Tax Relief Reconciliation Act of 2003. It provides that, retroactive to the beginning of 2003, qualifying dividends are taxed at a 15% rate, or at 5% if the taxpayer falls within the 10% and 15% tax bracket. (The same rates apply to capital gains, but only if the gains are realized after May 5, 2003.) To be eligible for the lower rate on dividends paid by a foreign corporation, the stock or depository receipt must be registered with the SEC and readily tradeable on an established United States securities market such as the Nasdaq, Amex or NYSE. Even if the readily tradeable tests cannot be met, the foreign corporate dividend may still be eligible if the company is either incorporated in a U.S. possession or is eligible for this benefit pursuant to a U.S. tax treaty with the country where it is domiciled. Here is just one more twist in the law to complicate tax filings for 2003.
- The average person gets a failing grade when it comes to investment matters. That's the conclusion of an investment literacy tests sponsored by Vanguard and Money Magazine. It found the following:
  - < Investors who didn't understand the inverse relationship between bond prices and interest rates - 70%
  - < Investors who were unaware the SEC requires mutual funds to disclose after-tax performance - 70%
  - < Investors who did not know income from municipal bond funds was Federally tax-exempt - 58%
  - < Investors who did not know what a mutual fund's expense ratio was - 75%
  - < Investors who don't examine tax implications of the investments they make - 79%
  - < Investors who did not understand the impact of fund expenses on fund returns - 64%
  - < Investors who don't know their Federal income tax bracket - 39%

Even more difficult to believe is the fact that, among those investors who utilize a financial advisor, 42% claim their advisor never discusses the impact of these matters on their investments with them. If you are in the dark about the implications of these matters on your investment portfolio, we can enlighten you!

## **REAL ESTATE**

- If you purchase, build or renovate a property for your business, at a minimum you should have your accountant perform a depreciation analysis or cost segregation study. The purpose is to segregate the cost into non-depreciable land, the building and structural elements which have shorter depreciable lives. The aim is to maximize the depreciation deductions which may be taken for tax purposes in order to recover the costs in the shortest possible time. This type of analysis may produce significant opportunities for charging off costs and lowering taxes in light of the more liberal bonus depreciation tax breaks provided under "The Jobs and Growth Tax Relief Reconciliation Act of 2003." The law increased bonus depreciation to 50% for property, including leasehold improvements, placed in service after May 5, 2003.
- The IRS has issued a reminder on the deductibility of some home refinancing costs. Accordingly, it indicates points to obtain a home mortgage loan may be deductible as additional interest by taxpayers who itemize. If the loan is used to purchase a home, or, if it is used in whole or in part for home improvements, the full amount of customary points paid, or the portion related to the home improvement may be deducted in the year the mortgage closes. Otherwise, the points have to be deducted pro-rata over the term of the loan. When refinancing a second time, or if the loan is paid off early, the taxpayer may deduct all of the remaining points not yet deducted in the loan payoff year. The IRS announcement also indicates mortgage closing costs such as appraisal fees and processing fees generally, are not tax deductible. Taxpayers are also cautioned, if their adjusted gross income exceeds \$139,500 (\$69,750 if married, filing separately), itemized deductions, including the interest deduction are subject to reduction as part of the itemized deduction phaseout. For 2004, the starting point for the phaseout is \$142,700, or \$71,350 for married taxpayers filing separately.
- Do you own a property which has appreciated considerably and that you want to sell? Are you concerned about incurring a large capital gains tax liability? One option is to structure the sale as an installment sale. Here the buyer pays the cost of the property plus interest in regular installments, usually for a period of 5 years, enabling the seller to reflect the capital gain for tax purposes over the entire payment period. Sellers who decide on this strategy are cautioned, however, that an installment sale carries more risk than an outright sale of the property. Thus, the seller needs to:
  - < Carefully assess the creditworthiness of the buyer and possibly obtain personal guarantees, if the purchaser is a business.
  - < Evaluate the future income-producing capability of the property to make sure it provides sufficient cashflow to enable the buyer to make the payments.

- < Use an interest rate that is competitive with current market rates in the area so as not to squash the deal.
- < Obtain a down payment of at least 20% to have a cushion in the event of buyer default, and to cover the expenses if foreclosure becomes necessary.

Business property transactions are often complex, and the services of a knowledgeable CPA can be vital in developing strategies that make it possible to bring a contemplated transaction to a successful conclusion.

## **TAXATION**

- The recently enacted Military Family Tax Relief Act doubles the death benefit payable to survivors of Armed Services members killed while on active duty, inactive duty training or authorized travel, to \$12,000, retroactive to September 11, 2001. Another provision of the law allows members of the uniformed services to ignore as many as 10 years of time spent away on official extended duty when calculating whether their houses were owned and used as their principal residences prior to being sold for purposes to enable excluding the gain on the sale. This break is retroactive to May 6, 1997, and sellers have until November 12, 2004, to claim refunds for tax years which were closed by the statute of limitations. The legislation also allows reservists to deduct their overnight travel expenses even if they don't itemize deductions. If their trip exceeds 100 miles, they can claim expenses they incur for transportation, meals and lodging up to the Federal per diem rate. This provision also applies to National Guard members.
- Since November 1, 2003, the IRS is charging a \$150 application fee to process offers of compromise made by taxpayers to settle outstanding tax liability at less than their full amount. Then, if an offer is accepted, it will be reduced by the fee paid. However, the fee will not be refunded if an offer is withdrawn, rejected or returned as non-processible after initial acceptance. The fee does not apply to offers where a genuine dispute as to tax liability exists or to offers made by taxpayers whose income falls below poverty guidelines set by the Department of Health and Human Services. The IRS hopes the fee will reduce the number of inappropriate offers being filed by taxpayers. Incidentally, user fees for letter rulings, employee plan rulings and exempt organization determination letter which were set to expire were extended through December 31, 2004, by recent legislation.
- The IRS has announced the 2004 tax rates and other inflation adjustments. Here are some highlights:
  - < The personal exemption amount rises from \$3,050 to \$3,100.
  - < The personal exemption phase-out starts, for joint returns when adjusted gross income exceeds \$214,050, and for most singles when it exceeds \$142,700.
  - < The standard deduction for married couples filing jointly rises to \$9,700; \$4,850 for singles and married couples filing separately; and \$7,150 for heads of households.

- < The additional standard deduction for aged and blind taxpayers increases to \$950 each (\$1,200 for taxpayers who are also unmarried and not a surviving spouse.)
- < The itemized deduction phase-out will start with adjusted gross income above \$142,700 (\$71,350 for married couples filing separately).
- < The monthly limit on the aggregate fringe benefit exclusion amount for transportation in a commuter highway vehicle and any transit pass will be \$100, and the cap for qualified parking will be \$195.
- < With respect to education credits, 100% of qualified tuition and related expenses not in excess of \$1,000 and 50% of expenses in excess of \$1,000 (same as in 2003) will be taken into account in determining the amount of the Hope Scholarship Credit. However, the adjusted gross income cap rises so that adjusted gross income in excess of \$42,500 (\$85,000 for joint filers) will be taken into account in determining the reduction in the amount of the Hope Scholarship and Lifetime Learning Credits in 2004.
- < There has been no change in the annual gift tax exemption which remains at \$11,000, but the estate tax exclusion rises to \$1.5 million.
- < Although the IRS has not made an official announcement, tax brackets are projected to be wider in 2004, and the increase in tax rates will occur at higher taxable income levels than in 2003 because the tax brackets are indexed for inflation. For example, in 2004 the 10% bracket is projected to apply to the first \$14,300 of income for joint filers and the first \$7,150 for singles.
- Employers are gratified employees will be allowed to use debit cards in conjunction with their flexible spending accounts, prompting more firms to consider adding these types of accounts to other benefit plans. Congress overruled the IRS and indicated companies won't be required to send 1099 forms to physicians who receive \$600 or more from cafeteria plans and health reimbursement arrangements such as flexible spending accounts retroactive to January 1, 2003. Undoubtedly, this is added fuel for adopting the debit card arrangements.
- The IRS is focusing on pay practices of exempt organizations and checking to see whether salaries and perks of executives are excessive. The Agency can impose penalties on insiders who are getting sweetheart deals and on managers who approve the pay packages. Such sanctions can be avoided if the pay is approved by an independent board which uses pay and perks paid at comparable organizations as a guide in setting pay. The Agency has found instances where the executives themselves are supervising the data collection or the exempt organization's independent accountants are furnishing the pay study, and views these practices as a conflict of interest. The Agency also intends to expand the types of charitable organizations it examines to check that they are in compliance with IRS regulations. Charities which raise and distribute funds for other groups, private schools and trusts set up primarily to benefit tax-exempt organizations, such as universities, are in the IRS' line of fire.

- Have you had the good fortune to win a prize in a contest? Frequently, businesses which award prizes inflate the value of the prize to enhance their own tax deduction when they send you a Form 1099. If this happens to you, shop around and determine whether the amount was overstated and do not pay tax on the inflated amount. Instead, reflect the amount shown on the Form 1099 on your tax return, then deduct the overstated portion and enclose an explanation with your tax return. You'll pay tax only on the real value of the prize you received. To be able to substantiate your action to the IRS, obtain documentation from a vendor who is selling the same merchandise at the lower price. You are entitled to use the lowest price for which you could have purchased the prize for tax return purposes.

## **PAYROLL TAXES**

- The Social Security Administration has announced the 2004 social security wage base will increase to \$87,900 for 2004. The tax rate remains unchanged for employer and employee at 6.2% up to the wage base for FICA and 1.45% for all salary for Medicare. The tax on self-employed is 15.3% on the first \$87,900 and 2.9% above that. The maximum OASDI tax that will be withheld from those earning over \$87,900 in 2004 will be \$5,449.80 and an identical amount will be contributed by the employer compared to \$5,394 in 2003. The tax is double the withheld amount for self-employed individuals. The Administration also indicated that for 2004, cash remuneration paid by an employer for domestic service in the employer's private home is not FICA wages if the amount paid during the year is less than \$1,400, the same as in 2003.

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