COMMENTS - OCTOBER, 2003

ACCOUNTING AND AUDITING

■ Contrary to the common belief that small companies are more dependent on their outside accountant for advice than large companies, a survey by the NFIB Research Foundation suggests that the larger firms seek business advice from their accountants most frequently. It categorized firms by number of employees and found that business was sought from accountants by:

< 55% of firms with fewer than 10 employees
< 69% of firms with 10 to 19 employees
< 74% of firms with 20 to 249 employees.

The results are actually not surprising since there is a correlation between business size and the need for specialized consulting services which CPA firms render.

■ Between mid-1997 and mid-2002, the SEC filed 2,508 enforcement actions for financial reporting and disclosure violations. It concluded that, in many instances, there were multiple violations. The major accounting manipulations took the following forms according to the Agency:

< Overstatement of assets by means of false asset valuations.

< Overstatement of revenue by improper timing of revenue recognition.

< Understatement of liabilities and expenses by improperly deferring expenses or incorrectly computing such items as depreciation.

< False, inadequate or omitted disclosure of related party transactions, loans to officers, and restructuring charges designed to enhance future results.

< Manipulation of core earnings by excluding recurring charges and inflating operating results and pre-tax income.

Unfortunately, generally accepted accounting principles, as they now stand, allow considerable flexibility with respect to financial reporting, so that it is possible for managements to utilize perfectly legal means to distort financial results, meet earnings forecasts or satisfy compensation arrangements which result in the award of large bonuses, stock options or other incentive compensation. Hopefully, recent legislation and regulatory changes as well as the general public outcry for reform will lead to more reliable financial information that is truly reflective of management's performance. In the interim, investors and other users of financial statements will have to rely largely on the perceived integrity and reputation of company management and financial statement auditors to make investment, lending and other financial decisions.

- The Financial Accounting Standards Board has voted unanimously to require that stock-based compensation be recognized as an expense in income statements, with amounts recorded at fair value measured at the date of grant. The decision ends years of debate over expensing of stock options in which various stakeholders chose opposite sides. For example, recently, the Competitive Enterprise Institute indicated it believes expensing of stock options is a bad idea, while representatives of the mutual fund industry have become strong proponents of the practice. So far, only a minority of the Fortune 1,000 companies have indicated they would begin expensing stock options sometime within the next 12 months. One reason for the reluctance is, currently, there has been no uniform standard for measuring the amount of expense that should be reported. Since this issue also has political overtones, there is likely to be considerable wrangling and debate over the details until an acceptable measurement standard has been achieved. Because of the importance of this issue, the Financial Accounting Standards Board has indicated it would issue an exposure draft of a financial accounting standard for stock options by the end of 2003. Since the rule-making body has debated expensing of stock options since the mid-1990s much of the technical details for developing a standard have already been resolved and the deadline seems reasonable.

ADMINISTRATION, SYSTEMS AND EDP

- Which electronic devices do frequent business travelers find most useful for keeping in touch with staff and customers? According to a recent survey of 1,400 chief financial officers, here is the order of preference:

Cell phone	46%
Laptop computer	33%
Hand held digital organizer	7%
Desktop computer	4%
Pager and telephone	4%
Miscellaneous	6%

  Is your firm monitoring the latest electronic communications devices to insure that traveling employees are utilizing the most efficient and secure equipment for enhancing customer service and maintaining business information flow with the home office?

- Recently, a major consulting firm asked a large group of business managers what their priorities are for the next 12 months. Here, in order of frequency were the responses:

Improve financial reporting	18%
Cut costs	17%
Prepare better forecasts	14%
Manage business growth	12%
Streamline business processes	12%
Find merger or acquisition candidates	8%

Enhance working capital management	7%
Invest in new technology	4%
Raise additional capital	4%
Improve the auditing process	4%

- Many companies had begun using web conferencing as a means of lowering their travel costs. It enables companies to use a web browser to share documents, spreadsheets, presentations and applications with hundreds of geographically dispersed people within or outside of the company simultaneously. Because of this flexibility, companies have found new applications for web conferencing. Examples include providing online training for employees, enhancing project collaboration among workers and providing product demonstrations for customers. Although larger companies are likely to develop their own web conferencing systems in-house, smaller firms who don't wish to make the capital expenditure because of limited resources or limited need, can contract with a hosted service provider and obtain web conferencing either as a one-time service or on a subscription basis. If you haven't focused on web conferencing possibilities for your firm, this may be a time to evaluate your needs.

- The fact that laptop and notebook computers are portable makes them particularly vulnerable to theft. According to the Gartner Group , a consulting firm, companies without an anti-theft policy regarding these machines can expect to experience a 5% or greater theft rate per year. Now there may be a solution at hand. An Internet tracking service company claims it can install software on a laptop that secretly transmits the computer's location as soon as the thieves hook it up to the Internet, enabling the police to track the equipment down and recover it. The company claims it has a 95% recovery rate with respect to stolen computers that were used to log onto the Internet. Annual fee for the service is about $50, and there are a number of companies in this business.

- Executives spend an average of 108 minutes per day reading and sending e-mail messages. This seriously diminishes their overall productivity, and negates the benefits of efficiency and lower cost that are attributed to e-mail. Accountemps, a temporary employment agency, recommends trying the following:

    - Sort incoming e-mail into labeled folders where they can be easily retrieved, and leave no messages in the in-box.

    - E-mail brief and clear responses. (Messages that require complicated or lengthy responses should be sent via another medium.)

    - Resist reading new e-mail messages as they arrive, and instead, set aside time several times a day to read and sort messages, and to respond.

    These ideas have proven helpful for dealing with e-mail traffic. You might also consider spam prevention. It's estimated that spam filtering techniques lower the time required to peruse e-mail by about one-third.

AGRIBUSINESS

- With some careful planning, farm income paid by a trust may be exempt from self-employment tax according to the IRS. In the specific situation, a husband died and bequeathed a farm to a trust for his wife and son. The trust paid the wife and the son separate fees for keeping the farm's books and for overseeing the farm's operations. The mother and son paid self-employment taxes on those fees, but not on their share of the trust's income from farming. According to the IRS, the farm income escapes self-employment tax provided the heirs were paid reasonable management fees for the work they were required to perform. Since this was the case here, the entire remaining farm income is not subject to self-employment taxes.

FEDERAL REGULATIONS

- The IRS has approved a new type of 529 tuition savings plan that will be administered by private colleges, instead of the states. Approximately 300 colleges are expected to participate at the programs inception later this year. Families that enroll will be able to buy future tuition credits at a discount from current prices. The participating educational institutions intend to hire a private firm to administer the program. It's expected the plan will have particular appeal to parents who want their children to attend their alma mater or enroll in a similar educational institution.

- The Department of Education announced new, lower student loan rates. Student loan rates are adjusted annually based on a formula which takes into account the 91-day Treasury bill rates. Accordingly, the new rates will be:

  < 3.42% for college graduates repaying a Federally guaranteed loan known as a Stafford Loan.

  < 2.82% for students still in school, recent graduates, or those deferring loans.

  < 4.22% for parents who finance their child's education.

  The new rates went into effect on July 1, 2003.

- The Department of Homeland Security has initiated a web site which offers valuable information to small businesses about potential business opportunities. The web site address is: www.dhs.gov. Besides providing information about how to do business with the new cabinet agency, it provides:

  < Rules for unsolicited proposals;
  < Importing and exporting, and
  < Disaster relief for business.

  A second web site named www.ready.gov specifically provides information for making disaster preparedness plans for work, school and home.

INSURANCE

- Split-dollar life insurance arrangements in which costs and benefits of life insurance are split between employer and employee have been a favorite tax planning tool for corporations and professional practices because usually the employer pays most or all of the premiums while the executive or professional pays relatively modest income taxes compared with the life insurance benefit obtained. However, the IRS and Congress have attacked these arrangements in the past year. Thus, in January 2002, the IRS issued Notice 2002-8 providing guidance for collateral assignment equity split-dollar arrangements, which are probably the most common type of split-dollar plans. Here: (1) the employee or a trust created by the employee owns the policy; (2) the company will eventually be repaid the premiums it has paid on behalf of the employee, and (3) the policy's cash value in excess of the premiums paid belongs to the employee or to family members named as beneficiaries. According to the Notice, the "equity" in equity split-dollar arrangements, i.e., the employee's access to the excess cash value may be subject to income tax in the future. In light of this and other negative IRS proposals, clients are wondering what to do with respect to these policies. Here, in general are some thoughts:

< Since split-dollar arrangements entered into before January 28, 2002, are grand fathered and thus still entitled to special tax treatment.

< If a collateral assignment equity split-dollar arrangement has been in place for 10 years or more and the cash value exceeds the premiums paid, terminate the plan and repay the premiums to the employer by borrowing from the cash value. (If you act before January 1, 2004, the equity in the policy will remain untaxed.)

< If the policy is fairly new, the cash value has had insufficient time to accumulate continue the arrangement. (Notice 2002-8 permits grand fathered plans to continue to use low term insurance company rates when calculating the value of the protection received, enabling the employee to pay little tax while obtaining substantial amount of insurance protection.) Conversely, if the employer is a publicly traded company, no further premiums should be paid, because the Sarbanes-Oxley Act treats such payments as illegal loans.

Of course, if an arrangement was entered into after January 28, 2002, the tax consequences tend to be unfavorable because of the taxation of the excess cash value and relatively high current income taxes. Accordingly, these arrangements should be avoided, and possibly, the split-dollar arrangements might be replaced with straight company loans. The regulations are extremely complicated.

■ Have you had sudden storm damage to your home or business, or been in an accident with your car? You are in all likelihood the victim of a casualty loss. To figure the amount of a personal casualty loss you must:

1. Calculate the decline in the fair market value of the property, i.e., the property's value before and after the casualty.

2. Reduce the amount of the loss in (1) by any insurance proceeds you receive.

3. Reduce the net amount in (2) by $100.

4. Limit the amount of the loss you can claim so that it may not exceed 10% of adjusted gross income.

If the loss occurs in a region the President has declared as a disaster area which qualifies for Federal assistance, you get the added benefit that you can claim the loss either in the year in which it occurred or in the prior year, enabling you to determine the year which will provide the greater tax benefit. In the event your insurance proceeds exceed the adjusted basis of the property which was damaged or destroyed, the excess would be treated as a taxable gain, but this can be avoided by reinvesting in replacement property within specified time frames, i.e., property which is similar or related in service or use to the property that was destroyed. The determination for a business casualty loss is usually simpler than for a personal casualty loss. Your uninsured business casualty losses are not subject to the $100 per casualty reduction amount, nor are they subject to the 10% of adjusted gross income limit. On the other hand, whereas individuals who receive Federal assistance following a disaster can usually exclude all or part of the payments from income, this exclusion is not available for businesses with respect to FEMA, SBA or other Federal assistance. We recommend, for substantiation purposes, clients retain records showing a property's tax basis and that they review insurance coverage annually to make sure the insurance is adequate to avoid undesirable exposure.

- Long-term care insurance is one of the insurance industry's hottest products, but before you decide to buy, it's important to determine your needs, because this is very expensive insurance. Essentially, these policies cover nursing home care and home-care costs. Here are some thoughts on this type of coverage:

  < If you have few assets you don't need this protection because you can probably qualify for Medicaid financed nursing home care.

  < If your savings and investments are sufficient to cover the annual cost of nursing home care and the living expenses of a spouse you can avoid the insurance because you can finance the cost yourself.

  < In effect, the insurance is primarily of benefit to people in the middle who have too many assets to qualify for Medicaid, but too few to pay for a nursing home.

  To figure out the amount of insurance you need, you should: (1) determine the amount of income you receive from social security, private pension plans and savings and investment; (2) calculate your current living expenses and the cost of a nursing home in your area, and (3) obtain long-term care insurance to cover the shortfall. Usually, this will result in a much lower coverage requirement than insurance salespeople will recommend. Furthermore, if you want to minimize cost, you might choose a policy that covers only a limited term, such as 5 years (the average nursing home stay is 2 ½ years) or opt for a policy that doesn't begin payments until 6 months or a year after you are deemed eligible. We'd also suggest not buying the cheapest policy, because the low premium may reflect an insurer's lack of knowledge about the true cost of long-term care and could lead to huge premium increases down the road if the insurer discovers it has been underpricing the product. Finally, we want to remind you all or a portion of your premiums may be tax deductible if the insurance is provided by a C corporation as part of an employee benefit plan or if you are self-employed, and company premiums paid or benefits received are not treated as income for tax purposes.

LABOR RELATIONS

- How do you reimburse employees for mileage they put on their cars when they use them for business? A recent survey reveals the following practices:

1. Reimburse employees at the IRS mileage rate	79%
2. Reimburse at a higher rate	3%
3. Reimburse at a lower rate	18%

  The survey was based on the practices of 368 large companies.

- One effect of the higher unemployment is that workers are taking fewer sick days. According to the Bureau of Labor Statistics, absenteeism is at a 10-year low. It reports that about 200,000 fewer employees per week are taking days off for health, personal and medical reasons than was the case in 2000. This is also borne out by anecdotal evidence from doctors who indicate that they are seeing fewer patients who are asking for sick notes while they are receiving more requests for prescriptions for pain killers to enable their patients to go to work. Incidentally, last year's sick days cost business an estimated $800 per employee.

- One source of administrative inefficiency which we encounter is the use of different pay periods for employees engaged in manufacturing and white collar functions, or for workers in parent companies and those of subsidiaries. While there may be perfectly logical reasons for the difference in pay periods, such as terms of union contracts, frequently they result from the continuation of practices which existed prior to a merger or acquisition and were never updated. It's estimated that at least 20% of companies have different pay periods and incur unnecessary payroll processing costs.

- The IRS says that employers with a 401(k) plan can allow employees with forfeitable vacation days to contribute the cash value of their unused days to the plan. As long as the employees do not have the option of receiving a cash payment in lieu of the vacation time, the 401(k) contribution is tax-free and not subject to payroll taxes either. The IRS says the contribution is treated as a non-elective employer contribution which is not taxable to the employees because the absence of a cash option means there is no income with respect to which the employees would be in constructive receipt. Finally, the vacation pay contribution is not taxed until it is distributed from the 401(k) plan.

MARKETING

- The Small Business Administration says international trade is no longer just for big business. It claims that 97% of all U.S. exporters in 2001 were small businesses and that they accounted for 29% of all U.S. goods sent overseas. Accordingly, it recommends small firms look abroad for new markets, to seek the opportunity for growth while conditions in the U.S. remain sluggish.

MONEY, BANKING AND CREDIT

- If you miss the deadline for obtaining a discount on a vendor invoice, it may be a mistake to pay the full amount of the invoice. About 75% of vendors have a grace period and allow the early-pay discount if payment is made within that time frame. The grace period varies by vendor, but 7 days is typical. The better a customer you are, the longer the grace period is likely to be extended.

- About one-fourth of accounts payable overpayments are the result of clerical errors made by the vendor or the payor go undetected. These might entail duplicate payments, erroneous payments, returns not credited, partial or advance payments that were overlooked or other adjustments. To test your firm's accounts payable processing accuracy, we suggest a periodic audit by your own personnel as follows:

    < Get a single vendor's file and all current outstanding invoices as well as checks that were written to the vendor in the prior 60 days.

    < Obtain the invoices paid and reconcile them with the amount on the vendor's statement.

    < Note in-transit items must be reconciled (checks sent, which the vendor did not receive by the statement date and checks prepared after the date).

    < Examine purchase order authorizations and receiving documents and be sure they match the invoice to which they are attached.

    < Trace the transaction to the journals and ledgers to determine the entries agree.

    < If you find discrepancies, expand the audit to several more vendors.

    When we perform audits for clients, we also vouch invoices on a test basis as part of our verification of the reliability of the client's internal control. If your firm is small and you do not require audited financial statements, and you have insufficient personnel to check on the accuracy of accounts payable activities, we can provide a limited engagement to verify vendor billings and your payment accuracy. An ancillary benefit of this type of engagement is that the same types of errors often recur with respect to payments to a particular vendor, so it may be possible to obtain a significant credit against future purchases from the vendor.

- Bank fees have escalated enormously in recent years, but there are some strategies for minimizing your costs:

    < Bouncing a check can cost you $25 or more. Therefore, to avoid a check being bounced, establish an overdraft account with the bank. This is essentially a credit line attached to your account, so, if there are insufficient funds in your checking account, you'll receive a cash advance from the overdraft account to cover the check. Of course, when you draw on the credit line the bank will treat the transaction as a loan and charge you interest until sufficient funds are in the checking account and the overdraft has been withdrawn. It's usually much less costly than the bounced check fee.

< Don't use your bank's ATM card on another bank's ATM machine unless it refunds non-branch surcharges. Fees as high as $4 per transaction are common.

< If you use your ATM card to make purchases, ascertain whether the store will allow you to obtain cash back on the transaction. As an accommodation to customers many stores allow this without imposing any fee.

These are just a few thoughts for making your money go further and managing your funds wisely.

PENSION AND ESTATE PLANNING

■ The IRS has removed a major hurdle for companies that wished to convert their defined benefit pension plan into a cash balance plan, which is a hybrid between a pension plan and a profit-sharing plan. Cash balance plans are less costly for employers, and they are more attractive for younger workers than the defined benefit plans. On the other hand, older employees whose benefits would be frozen under the new plan would suffer. Now the IRS says it will relax non-discrimination rules which limited employers from providing relief to the older employees whose benefits would otherwise be frozen after a plan conversion.

■ The IRS is making it easier for sponsors of qualified retirement plans to correct defects and avoid disqualification via its Employee Plans Compliance Resolution System. Recent changes in the system provide:

< Expanded programs to cover small business retirement plans such as Simple IRAs and SEPs.

< New correction methods and reporting instructions especially for small businesses.

< Fixed fee schedules for all voluntary submissions with fees based on the complexity of the problem being corrected.

< Streamlined Voluntary Correction Programs that consolidate seven subcategories of voluntary correction procedures into one.

< Less sponsor information requirements in a voluntary correction application.

< Sample submissions that plan sponsors can use as guides for their own voluntary correction application.

■ Funds participants have in qualified retirement plans, such as 401(k) plans, are subject to estate taxes when the account owner dies, and to income taxes when distributions are made to beneficiaries. These combined taxes can wipe out a large part of the value of the funds in the account. One way of avoiding this consequence is to have your retirement account invest in life insurance on your life, with the plan's trustee as beneficiary, and also have beneficiary instructions on file. Under this approach, the insurance premiums are paid with pre-tax dollars and the policy benefit in excess of the policy's cash value becomes income tax free. Therefore, the benefit can be paid to the beneficiaries by the account free of the normal tax, or it can be used to pay estate taxes. In the latter case, the insurance that was paid with pre-tax dollars is used to pay a tax bill that would otherwise have to be paid with after-tax dollars. Of course, for this strategy to work, the retirement plan must authorize investing in life insurance, and the plan trustee must know the tax rules governing life insurance. The cash value of life insurance is an asset of the account, so that upon the owner's death, the spouse becomes eligible to make a tax-free rollover of the cash value into an IRA. Failure by the trustee to realize this could result in the trustee paying out all of the insurance proceeds and unwittingly exposing the cash value amount to income tax. It's important for pension plan participants to engage in ongoing pension planning with a professional tax advisor to avoid serious mistakes in both planning and administration.

- The IRS has issued final regulations regarding the notices to be provided by plan administrators to pension plan participants and beneficiaries when there is a significant reduction in the rate of future benefit accruals or the elimination or significant reduction in an early retirement benefit or retirement-type subsidy. Generally, the notice must be given 45 days before a change, but the period is reduced to 15 days for multi-employer plans.

- Did you know that, if you were married for at least 10 years, you may qualify for higher benefits based on your ex-spouse's work record rather than on your own? Furthermore, you may be eligible even if the former spouse has remarried, provided you haven't remarried, as long as you and the former spouse are both age 62 or older and you have been divorced for at least 2 years. (The 2-year period is waived if your former spouse was already receiving retirement benefits before the divorce.) The right to benefits based on an ex-spouse's record is absolute and can't be relinquished by a separation or divorce agreement. However, once you remarry, your right to collect benefits based on a former spouse's work record ceases. Also, if you've been married and divorced more than once, you'd be eligible for the highest benefit based on whichever ex-spouse's work record provides it. Without some professional advice, many social security recipients could overlook this and other special rules and obtain lower benefits than to which they are entitled.

PERSONAL FINANCIAL PLANNING

- One way to minimize taxes in a divorce is to set up an alimony trust under Section 682 of the Internal Revenue Code. Here, although trust assets may revert to the grantor, alimony trusts are treated as non-grantor trusts for tax purposes. Thus, the spouse receiving distributions of income is taxed thereon, but the undistributed income is taxed to the trust grantor. (Trust income designated as child support in the divorce decree or separation agreement that is distributed is included in the taxable income of the paying spouse rather than the recipient.) Furthermore, a properly structured alimony trust that owns life insurance policies will pass the proceeds free of estate taxes as an added benefit. A word of caution: The section 682 rules are applicable to people who are divorced or legally separated under a decree of divorce or a written separation agreement. Because marriage dissolution is fraught with many tax pitfalls, people today place equal reliance on their tax and financial advisor as on their attorney.

- The combination of high bank rates on loans and high fees for services combined with layoffs or reduced salaries and declining income from investments have many people in financial difficulty. According to Cambridge Credit Counseling Corporation, the principal reasons for accumulating excessive debt included overspending and a lack of financial know-how for determining their debt carrying capacity. To a lesser degree, people run into financial problems because of an unanticipated illness or marriage dissolution. We encourage those who are experiencing debt problems to seek some professional help in establishing a viable personal financial plan which includes an assessment of their net worth, budgeting, and ongoing review of their affairs. In most instances their financial problems are solved within a reasonably short period, and they begin building the capital necessary to meet such goals as providing a child's education, starting a business, owning property and making other investments.

- One way to enhance participation by employees in company retirement plans is to provide financial planning education. However, workers will attend these education sessions or seminars only if they consider them relevant to their personal needs. Financial planning subject matter that resonates with most employees includes:

  - Improving your lifestyle to live more comfortably.
  - How to help children financially as they become adults.
  - Owning a home or trading up to a bigger house.
  - Paying for a child's college education.
  - Financial planning for early retirement.
  - Changing life insurance needs at different stages of your life.
  - Establishing an estate plan.

  These topics can be used effectively with seminars on basic personal financial planning and tax planning, to give your employees a foundation for financial decision making. Aside from providing a desirable objective, financial education seminars also enhance employee morale, when the participants feel they are receiving relevant and useful information.

- The tax break for heavy SUVs used in business is expanding. As a result of the recent tax legislation, the maximum amount of a qualifying vehicle that can be expensed has been raised from $25,000 to $100,000. To qualify, the vehicle must be put to business use this year and have a loaded gross vehicle weight rating over 6,000 pounds. To use expensing for autos, the curb weight must exceed 6,000 pounds. The maximum first year depreciation write-off for automobiles which do not qualify remains unchanged at $7,660 this year.

- The Administrative Office of the U.S. Courts says that the record-setting pace of personal bankruptcies continued this past year. In all, the bankruptcies rose 7.4% through the fiscal year ended on March 31st of this year, with 1,573,720 individuals filing for bankruptcy. About 80% of the bankruptcy filings were under Chapter 7 of the U.S. Bankruptcy code which lets people dissolve credit card and other debts.

- Many Americans are becoming increasingly worried about their personal finances according to the Consumer Federation of America and the Financial Planning Association. Although the financial problems of many people stem from a lack of adequate saving, frequently they are caused by common financial planning errors and investment mistakes. Among the most painful mistakes are those that impact on their retirement funds. Here they are:

1. Neglecting to consider the need for long-term care.

2. Not incorporating the effect of inflation and taxes into their projections.

3. Failing to maximize retirement set-asides in the years preceding retirement.

4. Overestimating the amounts that can be safely withdrawn without prematurely exhausting the retirement fund.

5. Over-managing a retirement investment portfolio which compounds investment mistakes.

6. Taking excessive investment risk.

7. Underestimating life expectancy.

8. Misjudging expenses in retirement.

9. Being so obsessed with retirement planning as to neglect other vital personal needs.

REAL ESTATE

- If taxpayers have more than one place they call home, determining whether they can qualify for the home sale exclusion to offset the capital gain on the proceeds from a sale of one of the residences can be difficult. One couple contested the IRS denial of the exclusion in the U.S. District court in Arizona with respect to a home they sold in Wisconsin and which they owned for the entire 5-year period prior to its sale. The couple had bought the home while they also owned a residence in Georgia, and they disposed of the Georgia property within the relevant 5-year period, and subsequently bought another home in Arizona. The couple told the Court they generally occupied the Wisconsin residence during the summer and spent the remainder of the year either in Georgia or Arizona during this period. The couple argued that the Wisconsin property was their primary residence, because they had spent more time in Wisconsin than in Georgia or Arizona during the 5-year period preceding the sale. However, they could not establish that the property had been owned and used as their principal residence for a period aggregating at least two out of the five years prior to the property's sale. As a matter of fact, the Court found that the taxpayers filed taxes and obtained a driver's license elsewhere pointed to the fact that Wisconsin was not their principal residence. Spending more time in one house than in the other residences does not meet the 2 out-of-5-year residence requirement according to the Court, and it sided with the IRS in denying the capital gains exclusion. Clearly, it's important for those who own multiple homes to maintain a written record of where they resided to support a claim for a capital gains tax exclusion on the disposition of a property.

- Real estate investors have been given a number of tax breaks under the new tax law. Thus:

  - Capital gains on the sale of properties held for a year or more were cut to 15% from 20%. (From 10% to 5% for those in the 10% and 15% tax brackets.) The lower capital gains rates are effective on or after May 6, 2003, through December 31, 2008.

  - The 30% bonus depreciation for qualified property increases to 50% for property acquired after May 5, 2003, and before January 1, 2005. Property includes equipment with a recovery period of less than 20 years or tenant improvements. (Property wouldn't qualify for the 50% bonus depreciation, however, if there was a written binding contract for its acquisition prior to May 6, 2003, although 30% bonus depreciation may still apply.)

  - The majority of real estate investment trust (REIT) dividends would continue to be taxed as ordinary income at a maximum new rate of 35%, when:

    - the individual taxpayer is subject to a lower scheduled income tax rate;
    - a REIT makes a capital gains distribution;
    - a REIT distributes dividends received from a taxable REIT subsidiary or other corporation ;
    - as permitted, a REIT pays corporate taxes and retains earnings.

  The REIT dividends would qualify for the lower 15% maximum tax rate on gains. (In recent years about 25% of REIT dividends would have qualified for the lower rates.)

TAXATION

- Homeowners who take out cash in a refinancing could be creating an Alternative Minimum Tax (AMT) problem for themselves. For AMT purposes, if the mortgage balance increases when refinancing a primary residence or a second home, interest on the excess portion has to be added back to income in calculating the AMT except when the proceeds are used to improve a first or second home. If, one the other hand, the excess funds are used to purchase a car or for some other purpose, the interest is not deductible for the AMT calculation. The same rules apply with respect to home equity loans.

- The IRS has clarified the deductibility of various medical expenses. It says the cost of reconstructive surgery is a tax deductible medical expense when a breast cancer survivor had a mastectomy. This is also true with respect to laser eye surgery, the cost of medical equipment such as crutches, blood sugar measuring kits and bandages, and the cost of finding an egg donor (i.e. payment of fees to the donor and the agency that found her, plus attorney contract preparation fees) when a woman could not use her own eggs in order to conceive a child. On the other hand, getting breast implants for cosmetic purposes, teeth whitening to improve personal appearances and the cost of non-prescription drugs do not qualify as medical expenses.

- The IRS will mail approximately 25 million tax refund checks beginning on July 25th and through August 8th, to reflect the increase in the Child Tax Credit from $600 to $1,000 for 2003 and 2004, was included in the Jobs and Growth Tax Relief Reconciliation Act of 2003. Taxpayers need to do nothing because the IRS will use 2002 tax return information to calculate the amount of the advance payment check. Eligible taxpayers who filed their returns after April 15, 2003, will get the checks later in the year, and taxpayers with children born or adopted in 2003 will not receive the advance payments because their tax returns did not include the child. In these cases, the taxpayers will claim the enhanced credits on their 2003 tax returns.

- One of the most overlooked and misunderstood tax deductions is "income in respect of a decedent." It is income that was payable to a deceased individual but which had not been paid or taxed prior to the person's death. The most common examples are amounts in an IRA, 401(k) plan or other retirement account. Other examples include:

  - Pension payments made to a designated beneficiary.
  - Deferred compensation from an employer.
  - Wages.
  - Damages in connection with a lawsuit
  - Joint and survivor annuities.
  - Investment income such as dividends and interest.
  - Payments in connection with an installment sale.

  Frequently this income is subject to double taxation because it is first included in the estate and taxed, and then included in income and taxed when it is distributed. To reduce the overall tax bite, the deduction for "income in respect of a decedent" enables the recipient of the income to take an income tax deduction for the estate taxes previously paid. The deduction for "income in respect of a decedent" must be taken as a miscellaneous itemized deduction, but it is not subject to the rule that limits the deduction to amounts which exceed 2% of adjusted gross income. However, since the deduction can only be taken as the income is received, it may be spread over many years (such as when a child takes distributions from an inherited IRA). Detailed records must be retained of the estate taxes paid on the income and the tax rate that must be applied on the income tax return. These may involve complicated computations, so that is advisable to have a tax professional retain the information and make the computations over the period the income is received.

- The Jobs and Growth Tax Relief and Reconciliation Act of 2003 was signed into law recently, and here is a brief summary of its provisions:

  - The top tax rate on dividends and capital gains was reduced to 15% through December 31, 2008. The dividend tax reduction is retroactive to January 1, 2003, while the capital gains reduction is effective for sales and exchanges made on or after May 6, 2003.

  - The tax cuts of 2% (3.6% for the 38.6% bracket) that were to take effect in 2004 through 2006, have been retroactively accelerated to January 1, 2003. The new rate brackets above 15% are: 25%, 28%, 33% and 35%. The rates above 15% are supposed to revert back to pre-2001 tax act levels after 2010.

- For 2003 and 2004, the standard deduction for married filers is being increased to twice that of single filers. After 2004, the standard deduction for joint filers would revert to levels enacted under the 2001 Tax Act.

- The Alternative Minimum Tax exemption has been raised for married couples to $58,000 for joint filers and surviving spouses and to $40,250 for single filers for 2003 and 2004.

- The "bonus" depreciation rate established by the 2002 Tax Act has been raised to 50% from 30% through December 31, 2004.

- The IRC Section 179, maximum annual expensing amount for small businesses has been increased from $25,000 to $100,000. The bill also: (1) increases the maximum capital expenditure permitted before the $100,000 expensing amount is reduced-dollar-for-dollar to $400,000 from the current $200,000; (2) permits off-the-shelf computer software to be expensed; (3) allows taxpayers to make or revoke expensing elections on amended returns without IRS approval, and (4) indexes the increased amount for inflation after 2003.

- The child tax credit has been increased to $1,000 from $600 for tax years 2003 and 2004. (Rebate checks started going out to eligible taxpayers on July 25, 2003.)

- States will be given $20 billion in short-term aid for tax years 2003 and 2004.

The legislation calls for the use of new tax strategies and revised tax planning for many people.

- The IRS' Offshore Voluntary Compliance Initiative (OVCI) had offered limited tax amnesty for people who came forward and revealed their use of offshore bank accounts and credit cards to evade taxes and also identify the promoters. Only 1,253 individuals came forth and identified 80 promoters and disclosed about $50 million in uncollected taxes. The IRS has 80 revenue agents and 40 attorneys assigned to promoter audits, and is now contemplating its next move. It says it has issued summonses to more than 70 U.S. companies that have accepted offshore credit cards for the payment of everyday goods and services and that it will move quickly to identify more promoters of offshore accounts and pursue holders of such accounts who did not come forth under the OVCI. The Agency says it will pursue civil or criminal penalties against promoters and non-disclosing taxpayers. The Agency has also indicated that, even though the voluntary compliance deadline has ended, taxpayers who come forth before the IRS has initiated a civil examination or criminal investigation, may seek some relief under OVCI. There may be over 1 million offshore accounts linked to credit cards issued in the offshore havens that have been used to evade U.S. taxes. Incidentally, 10 states have announced they will grant special consideration and avoidance of prosecution to taxpayers applying under the OVCI if they will amend their state tax returns and pay all taxes, penalties and interest by October 15, 2003. The states are: California, Idaho, Louisiana, Maryland, Nebraska, New Jersey, New York, North Carolina, Utah and Vermont.

PAYROLL TAXES

- In a decision that will enable many non-profit social clubs to lower or eliminate their tax liability, the IRS ruled that a social club may take into account all sources of tip income from members as well as non-members when calculating its social security income tax credit under Section 45B of the Internal Revenue Code. The ruling related to a club which operated a golf course and clubhouse only for members, but non-members could use the facilities and the amenities of the club if they were invited guests of members. The clubhouse-restaurant employees received tips from members and non-members in addition to their hourly wages, and the employees reported the tips to the club, which reported them on its employment tax returns. The club claimed a credit for social security taxes paid on employees' tip income when calculating its own tax liability. The IRS recognized that both members and non-members gave tips to employees after purchasing food and drinks at the club and that the club did not segregate the tips but paid employment taxes on all of the tips reported. The IRS concluded Section 45B does not limit the credit to social security taxes to tips of non-members only and, accordingly, the club's computation of the credit, taking into account all tip income, was permissible.