

COMMENTS - JANUARY, 2003

ACCOUNTING AND AUDITING

Family businesses only have a 3% - 5% chance of surviving to the fourth generation. Much of this has to do with discord among the owners, a lack of communication among the principals and inadequate succession plans. If these problems plague your family business, your CPA may be able to help.

- Growth planning.
- Organization design which reflects changes in business processes, procedures and technology.
- Operational efficiency and effectiveness audits.
- Management assessments and leadership development strategies.
- Communications enhancement among family owners.
- Customer service improvements.
- Business succession planning.
- Management and ownership transition requirements.

Frequently, the objective, unbiased view of a trusted professional advisor is the best catalyst for enabling a small business to withstand generational changes and devise long-range goals for business success.

It takes the average business six days to close its books. Yet 50% of firms report their closing cycle is eleven days or more. If your firm's closing cycle exceeds the average, you may be using antiquated systems and procedures to accumulate and summarize vital management information. An independent review of your accounting system could be the first step in enhancing your financial control and management decision making which is needed in today's competitive business environment.

FEDERAL REGULATIONS

The Department of Labor has issued a final rule giving employee benefit plan administrators the option of using e-mail, the Internet and other computer-based systems for making disclosures required by the Employee Retirement Income

Security Act of 1974 to plan participants and beneficiaries. The regulation requires that, on the initial day of a plan's first year beginning on or after October 9, 2002, plan participants and employees must give their consent to electronic delivery and be able to obtain paper versions of the documents on request.

- # The new whistle blower protection under the Sarbanes-Oxley Act applies to both publicly-held and private firms. Under the legislation, anyone in a supervisory role can now be liable for any retaliation taken against employees who disclose fraudulent business practices, and violators can face up to ten years in prison. It is important to inform supervisors and managers of the provisions of the law, and to inform employees of their right to voice concerns about business practices without fear of retaliation.

INSURANCE

- # If you are in the habit of submitting small claims to the insurer which provides your homeowner's policy, think twice. Insured's who submit more than a specified number of claims over three years are often tagged as frequent filers with the result the insurer may not renew the policy or may substantially increase your premiums, claiming you are a high risk. To avoid this scenario, many people pay for small damages out-of-pocket rather than submitting a claim, while others use higher deductibles and "self-insure" for minor damage to the property. The latter group not only avoids becoming a "high risk" insured, but also gets the benefit of a 10% or more premium reduction by increasing the deductible to \$500. Of course, the higher the deductible, the lower the premium, so one really needs to evaluate the amount of risk one can afford and limit excess insurance.
- # Are property and casualty insurance cost increases driving you into the poor house? Many people are disturbed about huge increases in insurance premiums, and here are some suggestions for getting them under control:
 - Increase deductibles.
 - Obtain home and automobile coverage from the same insurer.
 - Increase home security and add a sprinkler system to obtain discounts.
 - Utilize group insurance whenever possible.
 - Compare policy limits and the value of insured property regularly to avoid excessive coverage.
 - Shop around to obtain the lowest possible quotes for your insurance needs.

It is very easy to obtain quotes via the Internet. Two sites which provide quote services are www.insurance.com and www.quotesmith.com.

- # Under the new trade law, workers who lose their jobs due to trade pacts can obtain a tax credit equal to 65% of the cost of purchasing a health insurance policy based on COBRA coverage provided by the employer. The government will pay the insurance company directly for the coverage provided beginning no later than August 1, 2003, with the workers paying the remaining 35% of the premium out-of-pocket. Also, workers who have lost their jobs due to trade competition and who later become eligible for trade adjustment assistance, will be given a second chance to purchase COBRA continuation health care coverage through the former employer, even if they rejected the coverage when they were originally terminated.

LABOR RELATIONS

- # Under pressure from the business community, the IRS has backed down from its plan to withhold FICA and FUTA taxes on the exercise of incentive stock options and employee stock purchase plan options. It now says it will continue the moratorium on withholding of these payroll taxes on the exercise of such options at least until January 1st of the year which follows the second anniversary of the publication of a final rule calling for withholding. Meanwhile, however, legislation has been introduced in Congress, permanently exempting ISO and ESPP options from payroll tax withholding. Incidentally, non-statutory (non-qualified) options are subject to FICA and FUTA taxes upon exercise.
- # Depending on the industry, employee theft ranges from 1/2% to 4% of annual sales. Although theft losses are estimated to amount to \$140 billion per year, occupational fraud is about four times as great. This encompasses check tampering, invoice kickbacks, skimming of receipts, merchandise theft and cash embezzlement by workers. Overall employee theft amounts to about \$4,500 per U.S. worker. Of course, some employers suffer far fewer losses than others.

Reasons may include:

- Thoroughness of job applicants' background checks.
 - Establishment of effective internal control systems.
 - Closeness of employee supervision.
 - Management attitudes about prosecuting offenders.
- # The decline in the stock market can lead to a tax trap for people who exercised incentive stock options to buy shares earlier in the year when prices were higher. The gain on the option, as defined by the Tax Code, may have created an Alternative Minimum Tax liability which is locked in despite the fact the stock price has since fallen. In effect, you could owe tax on a larger amount than the stock is currently worth. In extreme cases, the AMT tax which is due could exceed the entire value of the stock acquired with the incentive stock options. Unfortunately, to know whether the Alternative Minimum Tax applies, your entire return has to be

completed and the tax liability computed using both the regular method and the AMT method. For people who will be subject to the Alternative Minimum Tax, a strategy for avoiding tax which may be greater than the value of the stock, is to sell the acquired shares by year-end, thus eliminating AMT tax liability.

MONEY, BANKING AND CREDIT

In order to obtain the highest possible interest rates, many people have gravitated to the Internet, rather than dealing with their traditional brick and mortar bank. For anyone making this switch, an important question has to be: "Are these deposits insured by the FDIC?" Here are the rules:

- If the internet bank has its own charter it is covered just like any other bank with respect to FDIC insurance coverage. Even if the internet bank is a subsidiary or an affiliate of another bank which is insured, it would still be insured separately by the FDIC so long as it has its own charter and insurance certificate number. In effect, a depositor which has an account at an internet bank as well as at the parent or affiliate bank would have insurance of up to \$100,000 at each bank even though the institutions are affiliated.
- Conversely, if the internet bank is a division of the parent bank and not a separately chartered subsidiary, and the depositor has deposits at both banks and the parent fails, the deposits at both banks would be added together because they are the same bank under the same charter, and any excess deposits over the basic \$100,000 of FDIC insurance would not be protected. This would also be the case even if the internet bank and the parent bank operated under different names.

It's absolutely essential, if you are making a deposit at an internet bank, to be sure the internet institution has a separate charter registered with the FDIC.

Credit bureaus use a "FICO" score devised by Fair, Isaac & Co to determine your credit eligibility. The score is comprised on five general categories which make up 100% of the credit score. They are as follows:

	<u>% of Credit Score</u>
Bill payment history (past 12 months)	35
Debt ratio (amount outstanding versus amount available)	30
Length of credit history (5 years or more is preferable)	15
Credit mix (amount of installment and revolving debt)	10
Frequency of shopping for new credit	10

If you want to enhance your credit score, the credit bureaus recommend: pay bills on time; keep accounts open because the higher the credit limit to your current

debt, the better; utilize credit cards to obtain credit and establish a credit history and check your credit report at least every 2 years to eliminate errors. The Federal Trade Commission also recommends people avoid credit repair companies because they frequently use fraudulent techniques to repair credit histories.

PENSION AND ESTATE PLANNING

- # The IRS has indicated pension plan reversions may be used by the employer to pay for matching funds the employer pays into 401(k) plans. The Agency also indicates when a reversion is used for matching funds there is no tax or penalty. However, to the extent the company retains the reversion, it is taxable and subject to a 20% rather than the usual 50% penalty. The IRS has also limited the amount of the pension plan reversion funds may be set aside for future matches to employee 401(k) contributions. Whereas it had originally indicated up to 100% of reversions could be set aside for future matches, it now allows only 25% of reversions of excess assets to be transferred to 401(k)s.

- # The IRS has issued final regulations governing distributions from IRAs and other retirement plans. Among the highlights:
 - Inclusion of new longer life expectancy tables than in the proposed regulations which allow retirees to reduce required minimum distributions. They are optional for 2002 but mandatory for 2003.
 - Beginning in January, 2003, IRA custodian will have to provide owners with either the required distribution amount, or advise them a distribution is required and offer to calculate it at the account owner's request.
 - Starting in 2004, IRA custodians will have to inform the IRS as to which IRA account owners are required to take minimum distributions.
 - A requirement that an IRA beneficiary has to be designated by September 30th of the year after the death of the IRA owner.
 - A provision that IRA's may be stretched out over the beneficiary's life expectancy and any distribution shortfalls are subject to a 50% penalty tax.

Although the final regulations automatically apply to IRA's, the IRS has made it clear it also wants all employer sponsored plans amended by the end of 2002.

PERSONAL FINANCIAL PLANNING

- # Electronic fraud is on the rise, and there are an endless number of scams to watch out for. According to the Internet Fraud Complaint Center in Washington, in order of frequency, they involve phone auctions, non-delivery of merchandise; credit and debit card fraud; home improvement fraud; phony investment schemes and manipulation of the stock market. You may also be solicited about an internet service called account aggregation, which enables you to organize and monitor

information about your bank accounts, credit cards, investments, insurance policies, frequent flyer miles and virtually all of your assets using a single Web site. As a precaution, before opting for this service:

- Obtain credit reports, check with state agencies and call the Better Business Bureau to determine whether the company is legitimate and there are no complaints.
- Review all terms and conditions of the service and make sure information you must provide is secure and not shared with anyone.
- Determine the timeliness of the information you will be receiving.
- Check with your financial institutions to determine whether they have had a problem with passwords and other information being provided to the aggregator.

Your bank or brokerage firm may also have knowledge of the firm which is soliciting your business. Since you have to provide such data as your password and account numbers to the aggregator, you had better be sure the firm is legitimate.

As the owner of a closely-held C corporation, your company could be attacked by the IRS as having paid you an unreasonable amount of compensation (base salary, bonuses, incentive pay, pension contributions and executive benefits). In turn, a portion of the pay would be recharacterized as a dividend to you and the company would lose the tax deduction while you would be taxed on the amount which is a dividend. Often, waging a successful defense against an IRS attack can deflect the IRS challenge. Here are some suggestions:

- Instead of setting your own compensation, have your executive compensation plan approved by a committee of the board of directors which includes outside directors.
- Have the company pay out some dividends each year so the IRS can not claim your pay was a disguised dividend.
- Have the base pay set at a relatively high level to total pay, since most unreasonable compensation challenges by the IRS are directed at other compensation areas.
- If bonuses are part of your pay, see that non-owners also receive bonuses as part of their pay package, and avoid paying bonuses to owners in proportion to their stock holdings. Also, establish a formula which is consistently used from year-to-year for determining bonuses to be awarded.
- Have an independent consulting firm prepare data showing your compensation is comparable to that paid by similar companies to executives

with the same responsibilities.

Since, determining "reasonable" compensation for a closely-held corporation is largely subjective, throwing up defenses against an IRS challenge may be half the battle in avoiding an IRS reclassification of your pay.

State college savings plans or 529 plans have many advantages for education and tax planning. Key elements include:

- Tax-free pay-outs if the funds are used for college education (tuition, fees, books, supplies and equipment) of the beneficiary.
- Absence of restrictions on use of the funds for any college in most state plans.
- Ability to change beneficiaries if the original beneficiary opts not to go to college. (This avoids a 10% penalty if funds are withdrawn and not used for education.)
- Treatment of pay-ins as gifts to the beneficiary, enabling a couple to give up to \$22,000 per year per beneficiary without gift tax. Donors who elect 5-year averaging for gift tax purposes can contribute \$55,000 (\$110,000 per couple) to reduce an estate and estate taxes.
- Use of funds from a 529 plan will not preclude use of the Hope and Lifetime Learning Credits if the funds are used for different expenses.
- Little impact on qualifying for financial aid, since the account balance is treated as an asset of the parents or grandparent rather than of the beneficiary.

Despite the obvious advantages, parents and grandparents should not rush into these plans. Here's why:

- Investment options may be limited and inflexible.
- There may be limitations and restrictions on institutions the beneficiary may attend.
- Cost of administration and other fees and expenses should be considered.
- There should be an evaluation of the cost of converting to another plan.
- Total pay-in limitations need to be compared to determine desirability of a plan.
- Past investment performance should be reviewed in plan selection.

REAL ESTATE

- # Here is a reminder for 2002, married taxpayers may exclude up to \$500,000 of gain on the sale of a principal residence if all of the following are true:
- They file a joint return for the year.
 - Either spouse meets the two-year ownership tests.
 - Both spouses meet the use test (having lived in the property as the primary residence for two of the last five years.
 - Neither spouse excluded gain from the sale of another home within the past two years.
 - Taxpayers who change principal residences due to a change in employment, health or other unforeseeable circumstances so they cannot satisfy the two year ownership and use requirements may still obtain a prorated exclusion. Here the \$500,000 exclusion of gain on the sale of their home would be based on the fraction representing the time they owned and lived in the property and the two year requirement.
- # The IRS says property managers must provide Form 1099-MISCs to property owners. In a private letter ruling, it indicated the 1099's are required if over \$600 in rents are passed through the management company and paid to the rental unit owner. On the other hand, the property management firm is not required to file 1099's on rents paid to real estate agents. This exemption applies to businesses which lease property and pay rents of more than \$600 to real estate agents, according to the IRS.
- # No-fee home loans have become increasingly popular with people who refinance mortgages. There are several variations of these loans. Among them:
- A loan where the lender pays all the fees for the borrower, but the borrower pays interest which is 1/4 to 1/2 percent higher than on a conventional loan.
 - An arrangement where the bank tacks on a mortgage fee to the loan, reducing the borrower's equity in the property.
 - A loan where the financial firm actually pays all the fees, but attorney's fees and other significant costs still have to be paid by the borrower.

Although there is a huge demand for these types of loans, borrowers are cautioned there are often significant long-term costs associated with them which may make them costlier than conventional mortgage loans. These costs may consist of a higher interest rate on the loan than on a conventional mortgage, or the fees may be wrapped into the mortgage balance so they are paid over the term of the loan rather than being paid up-front. In effect, lenders are not making gifts to

homeowners, and a no-fee mortgage loan does not mean it is less costly than a conventional home loan.

TAXATION

How long should you keep your tax records? The short answer is: "As long as they are relevant to the income and deductions claimed on the return!" In general, the IRS has three years to audit your tax return; but, under certain circumstances it has up to six years to do so. Accordingly, this would be the minimal period for retaining tax records. More specifically:

- Tax returns, financial statements, corporate stock, corporate records and minutes and real estate records should be kept permanently.
- Asset and depreciation records, home improvement records and investment records should be kept for the period of ownership plus seven years.
- General ledger, journals, bank statements, canceled checks, mileage, travel, entertainment and inventory records should be kept for seven years.

Realize these are general record retention time frames.

The Tax Court has allowed a teacher to claim a home office deduction for a portion of a residence used regularly and exclusively as the taxpayer's principal place of business. The music teacher used two bedrooms in his apartment for business activities. One was used as an office and contained a bed, a dresser and a tea stand for organizing student papers. The other was a studio which contained an electric musical keyboard, other recording and sound equipment and a bed used by the taxpayer when he worked late. The Court denied the deduction for the office because it was primarily used for personal purposes, but it held a portion of the studio qualified for the deduction because it met the exclusive use test. Thus, the portion of the studio containing the instrument and equipment qualified. It did not matter there was no wall dividing the portion of the room used for personal purposes and for business, because the law does not require the area to be partitioned according to the Court. Accordingly, the taxpayer was allowed to deduct three-quarters of the rent and other costs related to the qualifying area of the studio. In an earlier case the Tax Court reasoned similarly in allowing a violinist to deduct all expenses related to her living room because it was used exclusively for her musical activities. Home office deductions represent one of the trickiest areas of the tax code.

Whether you have lost a job or are still working, you may be able to deduct the cost of looking for another job. The tax law states job hunting costs are a tax deductible employee business expense when you look for a new job in your previous line of work without changing careers. Such expenses as employment agency fees, counseling fees, resume preparation costs, phone calls, travel and lodging incurred looking for work, and 50% of meal expenses and related costs are tax deductible provided you itemize your deductions on your tax return. The

expenses are treated as miscellaneous itemized deductions which are tax deductible to the extent they exceed 2% of your adjusted gross income. Of course, you should maintain records and receipts so you can substantiate the deductions.

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