COMMENTS - FEBRUARY, 2003

ACCOUNTING AND AUDITING

Contractors, attorneys and others who devise a system for tracking revenue and costs by job or project obtain the benefit of:

- Determining, on an ongoing basis, which jobs are profitable and which are not.
- Submitting timely billings to customers or clients.
- Avoiding commitment of resources to projects where payments are overdue.
- Knowing the cost per item if the company is engaged in manufacturing.
- Establishing competitive selling prices which insure cost coverage plus an adequate profit.
- Making sound management decisions about product lines which should be expanded and those to be discontinued.

While traditional cost accounting lends itself primarily to manufacturing businesses, service businesses can often obtain reliable information towards achieving the same objectives by utilizing activity based cost (ABC) accounting. Here, rather than obtaining costs in the traditional way, companies try to determine the activities required in providing services to their customers and the related costs incurred in establishing the selling prices.

Owners of public companies know the value of their company because the stock is publicly traded and the market value of the firm can be easily calculated based on the share price. But owners of private companies have a much more difficult time assessing what their firm is worth. Yet, a valuation is usually required for:

- Estate planning purposes.
- Establishing the terms of a stock buy-back agreement.
- Obtaining adequate business insurance and life insurance for the owners.
- Evaluating a business purchase offer from another firm.

Business valuations may differ depending on what is needed. Nevertheless, closely-held business owners who obtain periodic valuations of their business, for whatever purpose, are generally in an advantageous position in dealing with purchasers, tax collectors, co-owners, spouses and others because they have relevant and current valuation data.

INSURANCE

- # The IRS has ruled premiums paid on life insurance policies which have been given to a charity are tax deductible. The Private Letter Ruling responded to a situation where the taxpayer intended to purchase a single-premium policy with the charity named as beneficiary, and then transfer the policy to the charity. According to the IRS, although state law requires the donor to retain title to the policy, all other benefits of the policy will belong to the charity; the IRS won't treat the transfer as a non-deductible gift of a partial interest. The premiums paid become deductible once the donor's right to cancel the transfer lapses, according to the Agency. Conversely, the IRS and the Tax Court have issued several rulings denying taxpayers a charitable deduction for payments made to a tax-exempt organization which used the funds to purchase and pay premiums on split-dollar charitable life insurance policies pursuant to which the charity would receive approximately 50% to 90% of the initial death benefit while the taxpayer's family trust would receive in the range of 10% to 50% of the death benefit. The denial of the charitable contribution deductions were based on the fact (1) the exempt organizations erroneously stated in their required acknowledgment the taxpayer received no consideration for their payments to the charity and (2) they failed to make a good faith estimate of the value of the benefit. In fact, the taxpayers received a benefit to the extent of the death benefit they would obtain under the split-dollar life insurance arrangements. The use of life insurance plays a significant role in tax planning, but professional advice is essential as the IRS and the Tax Court are becoming increasingly aggressive in denying insurance related tax benefits.

- # In its continuing attack on abusive tax shelters, the IRS is pursuing a tax shelter arrangement which utilizes split-dollar insurance to pass wealth tax-free to future generations, and is also threatening retroactive enforcement. The scheme involves use of incorrect policy transfer valuations for tax purposes. For example, the taxpayer may use one valuation method to determine the premium on a policy, but then use a much lower valuation method to calculate the value of the gift in order to avoid taxes. The IRS announced details of its crackdown in Notice 2002-59.

- # Despite the fact workers' compensation benefit payments and costs declined as a percentage of wages in 2000 because of strong wage growth and a decline in reported accidents, the favorable results have not been translated into lower costs for most employers. On the contrary, escalating medical costs are resulting in rising (17% on average), rather than declining workers' comp premiums. Therefore, it is important to monitor claims carefully, as well as to review audits for proper worker classification to contain overall costs.

LABOR RELATIONS

According to some payroll experts, numerous companies are in violation of the Fair Labor Standards Act because the definition of "hours worked" under the law is extremely confusing. The most common errors are:

- Failure to pay for <u>all</u> hours worked.
- Allowing people to work through their lunch hour.
- Failing to pay for unauthorized overtime.
- Providing non-exempt employees with compensatory time off instead of pay.

These situations usually come to light because an employee lodges a complaint which leads to a Department of Labor audit. Approximately 78% of Department of Labor audits stem from employer complaints. If the Agency finds violations the fines can be substantial. Check with an attorney if you are unsure about your compliance with the Act.

The U.S. Chamber of Commerce reports employees at companies it surveyed received an average of $16,617 worth of employee benefits in addition to wages in 2000. The cost of the benefits represented 37.5% of total payroll cost among the survey participants. Following is a percentile breakdown of the cost of benefits:

	% of Cost
Medical benefits	29%
Payments for time not worked (coffee breaks, etc.)	26%
Legally required payments	23%
Retirement and savings	17%
Miscellaneous	5%

The survey also indicated smaller companies spend about 29.4% of payroll on benefits. Unfortunately, employees are frequently unaware of the cost of employee benefits and fail to consider them in evaluating their earnings. Therefore, employers should establish records of benefit costs for each employee and communicate the value of the benefits either with each pay statement or on an annual basis. Studies show when workers are informed of the value of the benefits, they are twice as likely to continue working for their current employer as those who do not have the information.

MONEY, BANKING AND CREDIT

The increasing number of business and personal bankruptcies are inducing firms to seek personal guarantees when extending credit to customers, and also to tighten

guarantee clauses to maximize their protection. Four key areas for strengthening guarantees are:

- Providing for unlimited duration and unlimited amount of the guarantee.

- Incorporating the right for the firm to pursue the guarantor at its discretion, enabling the firm to go after the debtor or the guarantor.

- Including a waiver which lets the creditor alter the customer agreement without the guarantor's consent. (In some jurisdictions this voids the guarantee.)

- Obtaining a guarantee from the parent's home office when dealing with a subsidiary company or a branch office of the parent.

Although mistakes in pricing, shortages in shipments, billing errors and the return of defective merchandise are common and usually legitimate deductions when dealing with customers, some companies are taking illegitimate discounts ranging from 10% to 50% of the invoice and claiming payment in full. Unfortunately, customers can claim any number of reasons for making only partial payments, and it is important the practice be monitored and repeat offenders be warned goods won't be shipped without payment in advance until repeat unauthorized deductions have been cleared up. In extreme cases it may even be desirable to stop doing business with a customer whose intent is to cheat you out of your legitimate profit. An effective way of ferreting out customers who take repeated unauthorized discounts is to audit all accounts at least annually to detect unauthorized discounts and extend the audit scope to all invoices for the year when you come upon a repeat offender.

Watch out for counterfeit cashier's checks. The availability of affordable high-quality scanners has made forging easier. Although many banks provide checks which have sophisticated security features, some banks are lax in their precautions. Our best advice is if you are uncertain about a cashier's check tendered by a customer, call the issuing bank listed on the check before parting with any merchandise or providing service.

PENSION AND ESTATE PLANNING

The stock market crash has wiped out over $7 trillion in investment values and about $700 billion in retirement savings. Put another way, every dollar invested in a Standard & Poor's 500 stock index in March, 2000, is now only worth 55 cents. Unfortunately, those who are over 50 are among the hardest hit and least able to recover their lost wealth. If you have become a victim, here are some suggestions for rebuilding your finances:

- Review your budget with a view to cut spending and raise savings.

- If you are still in the labor force, consider staying on the job longer.

- If you are retired, try to find part-time employment rather than opting for volunteer work.

- Prepare a net worth statement which incorporates the value of all of your assets in order to get a better handle on your actual financial circumstances.

- Figure out when you will need to rely on cash from your investments, to help you ladder investments and to avoid undue risk.

- If you are shifting funds into CDs, check rates carefully. Rates can vary by 1% or more on CDs of the same maturity.

- Evaluate the desirability of putting some funds into a single-premium annuity to enhance current income. These are complex contracts which require expert evaluation.

- If you cannot match your cash flow with your needs, consider a home equity loan, use of a reverse mortgage or trading down on your home.

It may also be a good idea to let your elected representatives know how you are faring, and the impact the artificially depressed interest rates are having on your golden years. Even if they do not read your letter, it will help you feel a little bit better.

If you intend to leave a bequest to a charity, your best bet might be to leave funds in an IRA, a 401(k) account or some other tax deferred retirement account to the charity. The strategy may help reduce income taxes owed by your heirs. The reason is retirement account funds are fully taxable when withdrawn from the account. However, if bequeathed to a charity, they can be income tax free. In turn, leave bequests of appreciated assets which receive a stepped-up basis to your heirs, minimizing their taxes when they are sold.

PERSONAL FINANCIAL PLANNING

Antenuptial agreements as well as pre-nuptial agreements are being used in about 25% of second marriages. These agreements attempt to: (1) define spouses' financial rights, duties and obligations during marriage and in the event of death or divorce; (2) protect the rights of children from a prior marriage; (3) prevent disputes related to property valuations, liabilities and contingencies; and (4) prevent inclusion of provisions which would induce the court to disqualify the entire agreement. In general, to be acceptable to a Court these agreements should reflect the fact there is no coercion, show fairness, provide for full disclosure of assets and liabilities, contain no provisions which contradict the law and provide for a spousal consent to waiver of survivor benefits in a retirement plan. Although these agreements are drafted by attorneys, accountants frequently play a joint role in their development. For example: accountants can develop an inventory of assets and liabilities; determine revenues, expenses and income if there is a business;

determine which accounting measurements are consistently made and in conformity with the desires of the parties or the instructions of the court, with respect to such issues as spousal support, property settlements, child support, and; provide planning which minimizes taxes. It is particularly important people with children from a prior marriage to recognize the importance of drafting for agreements and avoid delays which frequently leave children unprotected.

If you invest in mutual funds, you need to be alert to a number of tax traps, or you will end up with adverse tax consequences. Among the most common mistakes investors make are:

- Purchasing a fund just before it makes a capital gain distribution.
- Paying unnecessary taxes because of failure to utilize a tax-managed fund.
- Buying a fund which owns a portfolio of bonds subject to the Alternative Minimum Tax.
- Purchasing a municipal bond fund which owns a lot of discount bonds, since the difference between the purchase price and the maturity value is ordinary income.
- Failing to realize an exchange between funds results in a taxable event.
- Not designating which shares you are selling when there is a partial sale of your holdings.
- Failing to deduct investment related expenses.
- Duplicating tax payments on dividends at the time the shares are sold, because of poor record keeping.

REAL ESTATE

Low interest rates are encouraging homeowners to switch to 15-year loans from the traditional 30-year home loan. Although the shorter loan period results in a higher monthly payment, since the interest rate on the 15-year loan is lower than on the original 30-year loan, the overall payment on the property is substantially lowered. For example on a $200,000 30-year mortgage with a 6.5% interest rate the monthly payment is $1,264.13 and the total payment is $255,088.92. On a $200,000 15-year loan at 5.9%, the monthly payment would rise to $1,676.92 but the total interest cost would only be $101,846.91.

TAXATION

Although the IRS audit rate is at an all time low, at some point almost every taxpayer receives a notice from the IRS stating he or she owes more tax. About 1 million people receive such notices each year, and they can cause a great deal of

emotion and anxiety. What is a rational response to one of these notices? To begin with, do <u>not</u> panic. Seldom do these notices lead to an audit, and even if you were the subject of an audit, almost one-fourth of IRS audits result in no change in tax liability.

Our suggestions for a rational response to an IRS notice are:

- Never ignore the notice.

- Consult your tax advisor, if he or she prepared the return.

- Submit a response which is short and simple. (Many issues can be resolved quickly and may just be the result of an innocent error by the IRS or the taxpayer.)

- Provide copies (never originals) of relevant documents.

- Use certified mail, return receipt requested to send your response.

- If you keep getting notices despite your response, contact the IRS Problem Resolution Office. (After the IRS sends four notices it can impose liens and take other enforcement action.)

- If an important issue is at stake, the amounts are significant, or there could be broad ramifications consult a professional tax advisor.

One benefit of having a CPA prepare your tax return is you will quickly appraise him or her of the problem, and you will be advised of the actions which must be taken as the matter progresses. Incidentally, most IRS notices are computer generated and resolved very quickly.

Some credit card companies offer a rebate program based on a cardholder's annual purchases. Here, participating merchants rebate a percentage of the revenue derived from cardholder purchases to the credit card company which then makes the rebates available to the cardholders. Cardholders have the option of having the rebates donated to a specific charity in lieu of receiving the cash. The IRS has indicated cardholders who choose this option can claim a charitable deduction for the year in which the credit card company transfers the rebates to the designated charity, and the following conditions must also be satisfied:

- The cardholder must make an affirmative election to donate the rebates.

- The cardholder must receive a written acknowledgment from the charity for amounts of $250 or more.

- If the card holder is an individual, he or she must itemize deductions on Schedule A.

Regardless of whether the rebates are donated to a charity or retained by the cardholder, they are not taxable income to the cardholder.

Filing a tax return late will generally get you little sympathy from the IRS, and it will impose penalties which can be quite onerous on top of the tax and interest you owe. Nevertheless, sometimes taxpayers can persuade the IRS to forgive the late filing by establishing "reasonable cause" for the late payment of taxes. It has forgiven penalties where:

- Serious physical or mental illness prevented the taxpayer from filing a timely return, even though the taxpayer was able to work.
- The taxpayer was the care giver of a child or elderly relative who required the taxpayer's attention almost continuously.
- Unusual business problems required the taxpayer to work in the business seven days a week for over two-thirds of each 24 hour day.

However, if you are a "chronic" late-filer, i.e., someone who has filed a return late more than once in five years, there is virtually no hope of penalty forgiveness.