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COMMENTS - MARCH, 2001

ACCOUNTING AND AUDITING

The Internet has spawned renewed interest by many firms in outsourcing their payroll function to their CPA firm or other specialized payroll preparation vendors. Typically, these services calculate the earnings of their clients' employees, prepare paychecks or make electronic funds transfers to employee bank accounts, update payroll records, file Federal, state and local payroll tax returns and provide year-end W-2 Forms for the client's employees. Fee schedules vary, but typically there is a flat fee per payroll as well as additional fees for check preparation and for direct deposit to the employees' accounts. Of course, the outsourcing firms still have to provide records to the payroll preparation firm indicating hours worked, pay scales, etc. for each employee. Nevertheless, the cost of outsourcing frequently compares favorably with having payroll prepared in-house.

ADMINISTRATION, SYSTEMS AND EDP

Although airport delays are viewed as hurting the productivity of business travelers, some major airlines are trying to change this perception. They are about to offer wireless web services to business travelers who are delayed, for a nominal fee, or, on an unlimited basis, for about $50 for frequent flyers. The Internet access will generally be made available at airline lounges. If the effort is successful, business travelers may find the lengthy delays are actually productivity enhancers.

It's estimated there are 500,000 victims of identity theft per year and businesses lose hundreds of million of dollars per year from computer crime and credit fraud which is linked back to the identity theft. It's not hard for thieves to obtain such key information as the victims' name, address, birth date, social security number and mother's maiden name and claim to be that person. Businesses usually have this confidential information on record for their customers as well as their employees and should take responsibility to protect the data from potential theft. Here are some pro-active steps firms can take in this area:

1. Conduct criminal and background checks on all employees before hiring.
2. Screen cleaning personnel and other service providers who have access to your premises.
3. Screen employment agencies which provide temporary workers.
4. Keep personnel data in secure areas and establish secure procedures for data services which utilize such information.
5. Utilize alternative numbers and identifiers in place of social security numbers.
6. Encrypt all personal and confidential information stored on computers.
7. Include photos on business cards used by employees.
8. Utilize shredders and other security procedures with respect to disposing of personal information.
9. Establish security procedures with respect to transmitting personal information via fax.

10. Erase personal and confidential information daily from voice mail, pagers, cellular phones or e-mail.
11. Use designated and secure printers and copiers for personal information.
12. Adopt a written privacy protection policy and require employees to acknowledge having received it.

While some of these measures are designed for larger organizations and may be too detailed and cumbersome for a small business, small firms should not be complacent because they may actually be more vulnerable.

FEDERAL REGULATIONS

The government wants passengers to obtain the best possible price on air fares. Thus, when travelers call the airline directly and ask for the lowest fare, the airline must inform them of Web-only advertised special deals the airline is offering. The Web-only promotions are intended to help airlines avoid paying travel agency fees, but in the past, airlines have frequently failed to mention these deals in the hope they can sell the caller a higher priced ticket.

INSURANCE

An option for the terminally ill with life insurance who are in need of significant funds for health care management and other expenses is to contact a viatical settlement company. These third-party companies will purchase the life insurance policy from the owner at a discount from the policy's face amount based on the insured's life expectancy and other variables such as premium cost and cash value of the policy, providing the owner with an immediate lump sum of cash. The Aids epidemic gave an immense boost to the viatical settlement industry and today there are many companies that offer to buy life insurance policies from people who are terminally ill or who no longer require insurance and might otherwise let policies lapse. In effect, these companies convert a death benefit into a living benefit. Unfortunately, the viatical settlement market is virtually unregulated, raising the specter of fraud and even foul play since the purchaser of the insurance has a financial interest in the early demise of the seller of the policy (the viator). According to the insurance industry, abuses can take the form of:

1. Misleading advertising and misrepresentations to induce people to sell policies.
2. Use of excessive discounts to cheat distressed individuals.
3. Misrepresentation by purchaser of life insurance whose intent is not to retain the insurance but to make a windfall profit through immediate sale of the policy to a viatical settlement company.
4. Failure by the owner of the insurance to reveal debilitating medical conditions and illnesses.
5. Failure by insureds to disclose purchase of multiple policies with different insurers as part of an overall insurance fraud.

In light of these circumstances insurers are aggressively seeking state regulations to protect themselves against these types of fraud as well as to obtain consumer protection against unscrupulous viatical settlement providers. While viatical settlement serves a useful economic function in specific situations, it is important people in distress protect themselves against unfair practices by utilizing a professional financial advisor who can evaluate the terms offered.

LABOR RELATIONS

Absenteeism per employee averaged only 2.1% in 2000 compared to 2.9% in1999. While this was a distinct improvement, the cost of absenteeism per employee remained at over $600 per year because of overall higher employment costs. One approach which is used by some firms to track lateness and absenteeism is the establishment of a point system. Here, a specified number of points is assigned for each lateness in excess of 15 minutes, and a specified number is assigned for each unexcused absence. The accumulation of points then provides an easy system for tracking excessive absences and lateness per worker as well as for the overall work force. Workers whose attendance is poor can then easily be identified and a determination made of special causes and remedies. In general, if absenteeism stems from an "entitlement" mentality, there is usually little that can be done. Alternatively if the causes are employee dissatisfaction with the job, or the existence of certain family responsibilities some remedial action may be possible.

MONEY, BANKING AND CREDIT

Although the credit card industry has spent great sums to convince credit cardholders online shopping is safe, the effort has largely fallen on deaf ears. A recent survey by a consulting group, indicates 63% of respondents considered web shopping with a general purpose credit card to be "somewhat" risky and 34% thought it was "very" risky. Only 9% of respondents felt Internet shopping with a credit card was "very" safe. However, the concern over credit card safety in connection with online shopping may soon be solved. Several companies are developing systems whereby the shopper will be able to obtain a one-time credit card number to be used for one particular transaction and then discarded. The number is used with the regular credit card but only the card issuer and user are aware a special disposable number is being used to effect the transaction. This prevents a hacker or other kind of cyberspace criminal from stealing the card user's actual credit card number to engage in identity theft and then launch a series of fraudulent transactions. It's also a plus for online merchants because it would eliminate the risk of chargebacks after merchandise has been shipped and the fraudulent use of credit card information has been identified. The disposable credit card numbers are expected attain wide use during 2001.

PENSION AND ESTATE PLANNING

Life insurance should be a part of any estate plan and keeping the insurance out of your estate so the proceeds will not be subject to estate tax should be part of your planning. In general, the proceeds of life insurance are not subject to estate tax if: (1) they are not payable to the estate or the executor, and (2) if the insured decedent did not possess any "incidents of ownership" in the policy (right to change the beneficiary, ability to pledge or assign the policy, right to borrow against the policy, etc.) at the time of death. If a spouse is the beneficiary of the policy, the proceeds go to him or her and the insured is the first spouse to die, there will be no estate tax on the policy proceeds, but they become part of the

estate of the surviving spouse where they will eventually be taxed. To avoid this consequence, a life insurance trust is usually established to become the beneficiary of the insurance proceeds. Typically such trusts are set up with the spouse as income beneficiary, and upon the spouse's death, the children are beneficiaries of any remaining principal. For these trusts to be properly structured, as we indicated earlier, the insured may not have any incidents of ownership in the policy and the trust may either purchase the policy, or, if an existing policy is assigned to the trust, the transfer must be completed at least three years before the insured's death. Besides the tax benefit, insurance trusts also lower probate costs since the trust passes outside the will, and they enhance monetary stability for the surviving spouse since a trustee can manage and invest the insurance proceeds and assure the surviving spouse derives adequate income. Of course, establishment of an insurance trust will generate legal fees, trustee's commissions and, possibly, income tax return preparation costs since trust tax returns may be required.

Do you, like most people, rely on your pension plan trustee to maintain records of the beneficiary designations you have made for your pension plans? Unfortunately, many banks and brokerage firms have flaws in their record keeping and may not be able to find the designations when you die. In that case, all of your pension planning associated with the beneficiary designations may be worthless and your estate will be designated as beneficiary with extremely costly tax consequences. To avoid this kind of mishap, we recommend the following:

1. Periodically call the pension plan trustee and ask for the beneficiary designations to determine that they are on file and correct.
2. Obtain copies of all beneficiary designations and retain them with vital documents such as your will.

The fact the trustee has your beneficiary designation on file at a particular time provides no assurance it is secure. Frequently, documents are lost because of business combinations, computer system changeovers or failures or movement of records to a new location. Therefore, it's advisable you obtain acknowledged copies of the beneficiary forms you sign from the bank or broker who is the trustee, and file these with important personal papers such as your will. Of course, you should check regularly to determine the records are on file with the trustee.

PERSONAL FINANCIAL PLANNING

In general, property transfers between spouses which are part of a divorce settlement escape tax. But this tax avoidance is granted only with respect to capital gains which would otherwise result when property is transferred between spouses or former spouses incident to a divorce. Ordinary income which results from a transfer between the spouses as part of the divorce settlement is taxable. For example, in one instance, when one spouse transferred Series E Savings Bonds to the other in connection with a divorce, the IRS ruled the accrued deferred interest on the bonds became taxable ordinary income to the spouse who owed them upon the transfer. Similarly, in the case of a divorcing husband who transferred stock options to his wife, the IRS held the stock options were taxable upon their transfer and the husband received compensation income equal to the fair market value of the options at the date of their transfer. Unless recognition is given to the difference in the tax treatment between capital gains and ordinary income in negotiating divorce settlements, inequitable results can easily occur. This is just one reason why it is now customary for people engaged in marital dissolution to utilize the services of a professional tax advisor in addition to obtaining professional legal advice.

REAL ESTATE

Although the $250,000 exclusion ($500,000 for a married couple) on the sale of a principal residence appears to be very generous, it may be insufficient to shelter all gain on the sale of a property for a number of reasons. For example:

1. Many elderly people who bought their home decades ago have a tax basis of $10,000 or less if they used the rollover provisions of prior tax laws.
2. The exclusion for a surviving spouse is limited to only $250,000.
3. Appreciation of a high priced home could easily exceed the current exclusion.
4. Failure to index the exclusion for inflation diminishes the benefit over time.
5. The exclusion is unavailable if a sale is made to a related taxpayer and in certain other circumstances.
6. Repeal of the "rollover of gain" provisions require that any gain in excess of the exclusion must be recognized even if another more expensive home is purchased within two years.
7. The exclusion is lost unless three separate 2-year holding period requirements are met. These relate to ownership, occupancy and the time elapsed since a prior sale of a primary residence.

However, there are ways in which the exclusion can be increased. For example, a $250,000 exclusion is available to each spouse even if a homeowner owns an undivided interest, so long as each party meets the use requirement, regardless of who holds title to the property. Similarly, unmarried joint tenants or tenants in common who meet both the use and ownership requirements are each entitled to an exclusion regardless of whether they are related. Also, a widow or widower who sells the house in the year the other spouse dies and elects to file a joint return is eligible for the $500,000 exclusion. Despite the generous real estate exclusion under the current law, planning with a tax advisor to avoid unnecessary taxes on the sale of a primary residence is essential.

TAXATION

Primarily because of higher gasoline prices, the IRS has raised the standard mileage rate for business use of an automobile to 34.5 cents per mile for 2001, from 32.5 cents per mile. The standard mileage rate for medical or moving use of an automobile also rises to 12 cents per mile in 2001, from 10 cents per mile, but the rate for charitable use of an automobile remains at 14 cents per mile. The standard mileage rate may be used by employees or self-employed individuals who own or lease a vehicle used in the business instead of deducting all of the actual fixed and operating expenses. Parking fees and tolls may be deducted separately when the optional standard mileage rate is used. Incidentally, the IRS says self-employed couriers who use their own vehicles to deliver packages to and from customers, just like newspaper distributors, may also use the standard mileage rate because these are not vehicles used for hire, such as taxicabs which may not use the standard mileage allowance.

- # The IRS recently reported 2.4 million married taxpayers filing joint returns in 1999 gave incorrect names or information numbers for one of the spouses. Since this mismatch can jeopardize the Agency's acceptance of their tax return, especially if filed electronically, the IRS will be contacting about 2 million taxpayers about the names and taxpayer I.D. numbers being used. The Agency also says that in the future it will disallow personal exemptions and other tax benefits claimed for any person whose name does not match his or her social security number on the tax return. Women who have changed their names because of a recent marriage or divorce might be particularly at risk, and would do well to obtain an updated social security card from the Social Security Administration by filing Form SS-5.

- # The IRS has extended the medical expense deduction to a number of new items. For example, people with light sensitive eyes can deduct the cost of sunglasses when prescribed by a doctor. This would even be the case if they are non-prescription glasses, provided the doctor maintains they are needed outdoors because sunlight is harmful to the patient's eyes. Similarly, fertility treatments including the cost of in-vitro fertilization and vasectomy reversals are now deductible as a medical expense deduction. It's important for clients to maintain a detailed record of all of their medical expenses so that we can determine the eligibility for a tax deduction.

PAYROLL TAXES

- # People employing domestic household help are required to withhold and pay FICA taxes from cash wages which equals an inflation adjusted amount. For 2001, the withholding threshold rises to $1,300 from $1,200. The IRS says very few people who employ nannies, housekeepers or other household workers pay these social security and Medicare taxes or file a Schedule H with their tax return. Last year it only received 294,000 Schedule H forms representing 1/4 of 1% of all individual returns filed. Low compliance can be blamed on insistence by domestic workers to work "off the books," excessive record keeping rules in connection with complying with Federal and state regulations and hiring of domestic workers through agencies which are supposed to handle the paperwork. At some point the problem will undoubtedly be addressed by the IRS and by Congress.