

COMMENTS - MAY, 2003

ADMINISTRATION, SYSTEMS AND EDP

- # Businesses can expect air travel costs to rise between 4% and 8% in 2003. That is the conclusion of Rosenbluth International, a travel vendor. American Express, however, believes the fare rises will be somewhat more moderate, in the range of 3% to 4%. In either case, travel costs will increase, and many firms are evaluating alternatives such as teleconferencing to minimize their outlays.
- # Here is a reminder that under the economic stimulus package enacted last year, businesses can get a 30% expensing allowance on machine tools and other equipment ordered after September 1, 2001, and before September 11, 2004. In effect, a business that purchased \$500,000 of equipment in 2002 would be entitled to a depreciation deduction of \$150,000, with the balance of the cost depreciable over subsequent years under the regular depreciation rules. To qualify, the equipment must have been placed in service by the end of 2004. If the projections of an economic pick-up for 2003 are correct, purchase of equipment might be timely now, especially with Uncle Sam's special expensing tax break.
- # Whenever companies are faced with adding to, or upgrading office equipment, the question arises: "Should we lease or buy?" There could be advantages to either approach. For example, the benefits of buying include:
 - Overall cost tends to be lower over time.
 - It is possible to extend use of the equipment beyond the lease period without incurring additional cost.
 - The equipment can be sold or traded in, and such a transaction can be timed to provide maximum advantage for the owner.
 - Regardless of how extensively the equipment is utilized, the company is not subject to any penalties.

Conversely, the advantages of leasing include:

- Usually less cash is required up-front, and payments are made as the equipment is used and generates revenue.
- There is no hassle with respect to disposing of old equipment.
- The lease payments can be deducted as an operating expense, lowering taxes.

(In a purchase the deduction would be provided by depreciation.)

- Leasing enables a firm to conserve its bank credit line.
- Leases offer a variety of end-of-lease options including purchase, return of the leased equipment, or extension of the lease arrangement.

In the final analysis, whether to lease or purchase depends on the terms of the alternative arrangements that are available, economic and financial issues that are specific to the firm, and the after tax results attained by use of one or the other method. We regularly provide purchase or lease analysis for clients planning to make capital purchases.

FEDERAL REGULATIONS

- # Recently, the President signed the Trade Act of 2002 into law. It contains a provision granting health subsidies in the form of a tax credit to displaced workers. Specifically, eligible workers who have lost their jobs through a trade related circumstance can obtain a 65% advanceable, refundable health care tax credit to help them maintain their insurance coverage under COBRA or certain state-based coverage options. The credit is also available to workers who are indirectly displaced by trade agreements, including farmers and fishermen, and to uninsured retirees who are 55 or older and not eligible for Medicare, and who receive payments from the Pension Benefit Guaranty Corporation. December, 2002, is the first month of eligibility for the credit which is figured on Form 8885, and then claimed on line 68 of Form 1040. The government is hoping to implement a system this year, whereby premium payments will be paid directly to the insurer, so that eligible workers can avoid having to pay the insurance expense out-of-pocket and subsequently have to claim the credit.
- # According to a report, "The Impact of Contract Bundling on Small Business," the number and size of bundled contracts issued by Federal agencies reached a 10-year high in fiscal 2001, to the detriment of small businesses. Among its findings:
 - Both the number and amount of bundled contracts reached a record in 2001.
 - For every increase in 100 bundled contracts, there is a decrease of 60 contracts for small business and for each additional \$100 awarded in bundled contracts there is a decline of \$12 in contracts for small businesses.
 - Although Federal agencies are required by law to develop annual percentage of expenditure goals for small businesses, currently the overall goal is to provide 23% of contracts to small businesses. However, small businesses have only received 16.7% of bundled contract dollars and 20% of all Federal prime contract dollars in 2001.

The President's small business plan which was announced last March indicated that efforts would be made to give small businesses greater access to government

contracts by avoiding unnecessary contract bundling, streamlining the contract appeals process, and ensuring that contracts are open to all businesses. Now, the Office of Federal Procurement Policy has indicated that it will make a number of proposed regulatory changes by the end of January, 2003, and undertake other initiatives so that small businesses have greater access to government contracts

- # The Treasury Department has issued three new rules relating to the U.S. Patriot Act, financial institutions and the role of CPAs in the fight against money laundering. The regulations, which will be enforced by the Treasury's Financial Crimes Enforcement Network, deal with suspicious activity reporting, anti-money-laundering program requirements, prohibitions on maintaining accounts for foreign shell banks and information sharing between the government and the financial community.

INSURANCE

- # Under the Federal terrorism insurance program, insurers have until February 24th to present contracts and quotes for terrorism coverage to their clients. Then property owners have 30 days after receiving the notice from their insurer to either accept or decline the coverage. If the property owner decides to decline the coverage, most lenders and investors will never be notified that coverage has been dropped because most loan documents and operating and partnership agreements require insurers to notify the lenders and investors only if an insurance policy has been canceled. To protect themselves, lenders should stipulate that borrowers may not decline terrorism insurance without the lender's consent once the 30 day period has run. This kind of modification is absolutely essential for investors and creditors to avoid unintended risk.
- # Disability is a far greater risk for a younger person than dying. Yet, more people have ample life insurance in place than disability insurance. Essentially, this insurance is protection against loss of income and the cost ranges from about 2% to 4% of annual income for women and 2% to 3% of income for men depending upon age. Some of the mopreunique uses of this type of insurance might be:
 - In conjunction with a buy/sell agreement that is triggered by death or disability.
 - As overhead protection for a small business owner who may be required to pay workers' salaries while the owner is temporarily disabled.
 - To protect the seller of a business in the event the buyer becomes disabled before the completion of installment payments to the former owner.

People who consider the use of disability insurance for these purposes as well as for obtaining income during a protracted period need to focus on:

- Definitions of illness and disability used in the policy which can affect coverage.

- Guarantees as to non-cancellability of the policy and basis for premium increases.
- Length of the benefit period that is desirable.
- Provisions for cost-of-living increases in benefits, and how they are measured.

Of course, the tax consequences of disability insurance must also be carefully evaluated. For example, if the employer pays the premiums, benefits are taxed to the covered individual. Conversely, if the person pays the premiums, benefits received avoid tax. However, disabled persons may still deduct medical expenses incurred in conjunction with their disability to the extent these exceed 7.5% of adjusted gross income, and may also include the cost of home improvements that enhance a disabled person's quality of life, such as the construction of ramps for a wheel chair bound individual. The rules governing disability insurance become extremely complicated and we recommend that professional advice be obtained both with the selection of suitable coverage and with maximizing tax benefits arising from a disability.

LABOR RELATIONS

- # The direct cost of workplace injuries amounted to \$40.1 billion dollars in 2001, and it is steadily rising. The leading cause of injuries are:

| | <u>% of Total Direct Cost</u> |
|---|-------------------------------|
| Overexertion | 25.5% |
| Fall on the same level | 11.5% |
| Bodily reaction to stress (bending, climbing, etc.) | 9.4% |
| Fall to lower level | 9.2% |
| Being struck by an object | 8.5% |

Considering the high cost and serious disruptions resulting from workplace injuries, virtually any business should evaluate working conditions for potential hazards and implement practices designed to minimize harm.

- # Here is a reminder that in 2003, employers can provide up to \$5,250 in tuition payments for non-job related schooling (including graduate level courses) to employees under a company-paid tuition plan. However, the tuition plan must be in writing, and there are also restrictions on tuition payments to business owners and their families. The IRS has ruled that tuition payments to more-than-5% shareholders are limited so that no more than 5% of total tuition plan benefits can go to them, and the same restriction applies to their spouses and dependents.
- # The IRS says that excess sick leave can be placed in a worker's 401(k) plan tax free. In the particular situation, the employer permitted workers who did not use all

of their sick days in a year, to exchange up to 5 days for a pay-in to their 401(k) arrangement. The employees were credited with an amount calculated on the basis of 20% of their normal hourly pay rate, and they could not receive cash for the unused leave. According to the IRS, the pay-ins are not subject to income, social security or Medicare taxes. Although usually social security and Medicare taxes are due on pay-ins to 401(k) plans, this did not apply here, according to the Agency, because the workers could not cash in the days.

MARKETING

Although most people find shopping and paying for merchandise over the Internet easy and trouble-free, there could be a variety of drawbacks. The most serious one is identity theft in which someone uses data you have provided, such as a credit card or social security number to commit a fraud in your name. Second, you might also be swamped with unwanted junk mail because many Internet web sites sell the information gathered about a customer to others. Then, of course, there is also the possibility that you could be dissatisfied with a purchase, and it might be much more difficult to return the merchandise and obtain a credit than when dealing with a brick and mortar company. To protect yourself, we suggest:

- Dealing with a company you already know, and that also has retail outlets in the area where you are located.
- Determine the company's privacy policy and security practices (encryption, etc) with respect to I.D. and other confidential information you are required to provide with respect to the transaction and never disclose your password to anyone.
- Evaluate your payment options from a security standpoint. Credit and debit card payments are most common and involve little risk if the data provided is encrypted. Other common payment options include use of "electronic cash" that can be downloaded; deduction from pre-arranged accounts with online payment services; add-ons to monthly utility bills, and electronic checks, which involve the use of instructions to have funds automatically transmitted from your checking account.
- Thoroughly familiarize yourself with the vendors' rules regarding refunds and returns, your right to stop payment and avoid entering into a transaction if vendor policies are not satisfactory to you.
- Consider use of a third party escrow service that holds on to your payment until you notify the service that you have received the merchandise. Cost may range from a minimum of \$15 to as much as \$60 on a \$1,000 purchase, however.

If you engage in online purchasing it is particularly important that you carefully examine your monthly credit and debit card statements and to determine that all transactions are properly entered and that there are no unauthorized transactions

included. The bottom line is, that Internet shopping can be both safe and easy, but you need to do your homework first before entrusting your personal financial information to an unknown web site.

MONEY, BANKING AND CREDIT

In spite of difficult credit conditions in this slow economy, some firms have been able to enhance cash flow through shrewd cash generating operations. These include:

- Use of acceleration clauses in credit agreements, which allow the creditor to demand payment of the entire balance of a customer's account plus interest in the event the customer's account becomes past due.
- Automatic debiting of customer accounts, which enables the creditor to transfer payments from customer accounts directly to their own accounts by being able to access the debtor's bank account.
- Selling unrecovered debt to financial firms that deal in bad debts rather than utilizing a collection agency. Here the bad debt recovery firm will pay the company a specified percentage of the receivables turned over to them in exchange for being able to recover the full amount of the debt.

These are just some thoughts for minimizing risk, generating cash and maximizing the value of receivables in a difficult economic environment. Since different firms need different prescriptions for returning to health, it's important to discuss each specific situation with your business advisors.

Get ready for another change in the currency. The Bureau of Engraving is going to add multiple "subtle" color hues in the background behind the standard black and green engraving on \$20, \$50 and \$100 bills. The \$20 bills are expected to go into circulation by the Fall of 2003, and the larger denomination bills about a year-and-a-half later. Since the color schemes will differ for each denomination, currency users will be able to recognize the denomination of the bill simply by looking at the colors. Although the colors are not intended to prevent counterfeiting of themselves, their use enables the Bureau to add a variety of features to the currency to deter counterfeiting.

This year, 1.2 million U.S. companies are expected to be selling in the export market. If you decide to sell abroad, one of your biggest concerns will be the eventual collection of the foreign receivable. There are no easy answers to this problem, but here are some suggestions that will better your collection chances:

- Have the bank involved with the transaction from the start.
- Obtain a good profile of your foreign customer so that you can establish the degree of risk entailed in the transaction.

- Carefully review the sales terms. Some firms use irrevocable letters of credit containing terms identical to those agreed upon in the sales contract. Also make sure that both parties to the transaction have a clear understanding of the documents that will be required to obtain payment.
- Recognize that even if you have a confirmed letter of credit, any errors it contains when it is received by the importer's bank could make the instrument useless.
- Utilize a technique known as "documentary collection." Here, the documents are held by the importer's bank until they are either accepted or rejected by the importer. This method of obtaining payment is fine if you have an existing relationship with the foreign customer, and it is used in the majority of foreign transactions.
- Try to obtain payment in advance. This is usually feasible only if other firms are not competing for business with the foreign customer. Sometimes advance payment terms offered in the foreign currency may induce the customer to enter into an advance payment contract. In that case, the exporter should enter into a "forward contract" with its bank to avoid exchange rate risk.
- Use global credit insurance if the prospective customer won't agree to use of letters of credit. The insurance protects against customer insolvency, customer default, foreign government moratoriums on payments to the United States and "transfer loss" such as a political or economic event abroad that prevents or delays payment. If the risk is high, you will be asked to provide co-insurance of 20% to 40%.

In a competitive situation, by focusing on payment terms, the method of collection, the currency of payment and the use of insurance, it is sometimes possible to win business from a foreign customer without exposing your firm to undue collection risk. If exporting is on your agenda, there are many ways in which we can be of assistance.

PENSION AND ESTATE PLANNING

- # 401(k) plans are not restricted to just providing retirement benefits. Recently an insurer received IRS approval to market a disability policy for 401(k) participants that will continue their prior level pay-ins to the 401(k) plan should they become disabled. Payment for the coverage would come from the employees' 401(k) accounts. According to the IRS, disability coverage is a permitted option for a 401(k) arrangement and the employees would not be taxed when plan contributions are made under the insurance policy, but tax would be due when proceeds are withdrawn.
- # If a closely-held business interest represents more than 35% of an estate, heirs can get a break in paying estate taxes on that portion of the estate for up to five years,

and the tax payments can actually be spread over, up to nine additional installments. However, the IRS is cracking down on estates trying to utilize the installment payment option. It is now asking the estate to post a bond as security or to give the IRS a lien on property during the installment payment period. Alternatively, property outside the estate could also be used as collateral to protect the IRS against failure of the estate to complete the installment payments.

The beginning of the year is a good time to review your IRAs to determine that they are producing maximum benefit and that they are properly administered. Here is a plan for doing so:

- Make your contributions as early in the year as possible to maximize tax deferral.
- Review your distribution strategy in light of the simplified distribution rules that were instituted in 2002.
- Make sure that you have named both a primary beneficiary and one or more contingent beneficiaries for each IRA.
- If there is more than one primary beneficiary, make sure that the way they are to share the IRA is clearly specified by a fraction, percentage or equally.
- Contact the IRA trustee to determine that properly executed beneficiary forms are on file and request copies for yourself.
- Make sure that your attorney and your CPA also have copies of the forms.

PERSONAL FINANCIAL PLANNING

The economic stimulus package that was passed in 2001 contained a provision providing for teachers, instructors, counselors, principals or school aides to deduct up to \$250 per year for unreimbursed expenses for classroom materials and supplies such as books, computer equipment and computer software. To be eligible, the person must work at least 900 hours during the school year at a "school" as defined by state law. Parents who teach their children at home rather than sending them to a school would not qualify according to the IRS, because the expenses have to be incurred in connection with a trade or business. Incidentally, the deduction is an "above the line" deduction to arrive at adjusted gross income so that non-itemizers can also obtain the benefit. Of course, you must save your receipts to be able to substantiate your outlay if the IRS comes calling.

Although many doctors may not be too keen about going online, patients express considerable interest in being able to communicate with medical professionals online. Harris Interactive recently conducted a poll of patients to find out the information they would like to access over the Internet. Most desired were:

Ability to ask about health care questions

| | |
|-------------------------------------|-----|
| without an appointment | 77% |
| Electronic appointment scheduling | 71% |
| Obtaining prescriptions for refills | 71% |
| Receiving medical test results | 70% |

While it is important that the communications fully protect patient privacy, this is an area that doctors and other medical care providers should explore. An added benefit of developing an automated system could be that it eliminates a significant amount of telephone communications between the medical provider and patients, enabling the former to be more productively engaged.

Only about one-third of family businesses make it to the second generation, and of these, only about one-half survive to the third generation. This is largely due to the failure of the predecessor generations to develop a common family vision of the business objectives coupled with a lack of succession planning. To avoid these consequences and achieve common goals about the family business experts suggest:

- Holding regular family meetings.
- Fostering an environment that encourages open communications so that dissenting views can come to the surface and be addressed.
- Extending communication to all members of the family whether they are engaged in the business or not.
- Establishing family and business policies well in advance of their need.
- Forming a board of advisors to provide experienced insight to enhance the business management.
- Establishing a succession plan before it is needed, and integrating it with strategic plans for the business.
- Utilizing professional advisors extensively to provide expertise in all aspects of planning.

The firm's CPA is in an ideal position to function as the primary professional advisor when it comes to succession planning since he or she has complete knowledge of the business operations as well as the personal financial circumstances of the business owners and is also highly trained in all business and financial matters. Furthermore, because of the confidentiality of much of the information to which the CPA is privy, he or she is also frequently the family's most trusted advisor.

REAL ESTATE

Both Fannie Mae and Freddie Mac have raised the size of home loans they help

finance by 7.3%. The effect is to raise the amount of a home loan the Agencies will finance to \$322,700 effective January 1, 2003, and to make an additional 210,000 to 250,000 borrowers eligible for financing by these Agencies.

- # More and more people are investing in two vacation homes besides their primary residence. As a result we are asked a variety of tax related questions. For example, clients want to know whether they are entitled to take property tax deductions for all three homes. The answer is that they may. However, when it comes to taking mortgage interest deductions, these are limited to only two properties, the primary residence and one vacation home. But the owners can switch between the two vacation homes from year-to-year, taking the interest deduction that provides the greatest tax benefit.

TAXATION

- # If you prepare your own tax return, or use a non-professional tax service, you may not be fully minimizing your taxes. One example is the deduction for medical expenses. Here is a listing of some often overlooked medical deductions: Acupuncture, alcoholism and drug addiction, ambulance services, artificial limbs and teeth, birth control pills, braille books and magazines, chiropractic medical services, contact lenses and eyeglasses, crutches, dental treatment, fertility enhancement, hearing aids, nursing care, laboratory fees, laser eye surgery, lead-based paint removal, learning disability associated tutoring costs and oxygen. Also, home improvements required for medical reasons, such as central air conditioning to combat asthma, and the cost of ramps and elevators to make the home accessible to disabled family members would also be tax deductible to the extent they exceed the increase in the value of the home. Conversely, nutritional supplements (unless available only by prescription), weight loss programs to maintain general good health, and items ordinarily used for personal living (unless required to alleviate a physical or mental defect or illness), are examples of items that are not deductible. You should also be aware that home improvements made for medical reasons are deductible to the extent that their total costs exceed the resulting increase in the value of the home, and that you may also obtain limited deductions for the annual premiums for long-term care insurance, based on your current age. When we engage in tax preparation for clients, our tax professionals inquire about a variety of life conditions in the prior year that might have tax consequences.
- # It is estimated that inflation adjustments and other changes for 2003 will result in a couple with a taxable income of \$100,000 paying approximately \$90 less in taxes this year than in 2002, and that for a single person with taxable income of \$50,000, the tax would decline about \$54 in 2003. Here are some of the key figures:
 - The tax rates of 10%, 15%, 27%, 30%, 35% and 38.6% are the same as in 2002, but the tax brackets to which these rates apply rise slightly with respect to the tax rates above 10%.

- The personal exemption amount rises from \$3,000 in 2002 to \$3,050 in 2003. The personal exemption phase-out occurs on joint returns with adjusted gross income between \$209,250 and \$331,750, and on single returns with adjusted gross income between \$139,500 and \$262,000.
- The standard deduction for married couples filing jointly rises to \$7,950; to \$3,975 for married filing separately; to \$4,750 for single individuals, and to \$7,000 for heads of household.
- The standard deduction for individuals who can be claimed as a dependent in 2003 remain at \$750 or the sum of \$250 and the individual's earned income, whichever is greater.
- The standard deduction amount for the aged (65 or older) and the blind remains at \$950 for each qualifying factor in 2003, and increases to \$1,150 for singles who are not surviving spouses.
- The 3% itemized deduction phase-out begins to affect taxpayers with 2003 adjusted gross income above \$139,500 (\$69,750 for married filing separately).
- Qualified transportation fringe benefits remain unchanged at \$100 for transit passes and transportation in a commuter highway vehicle, and at \$190 for qualified parking.
- The gift tax annual exclusion remains at \$11,000.
- The luxury automobile excise tax of 3% on vehicles over \$40,000 is eliminated.
- Maximum credits and phase-out threshold with respect to the earned income credit (EIC) are as follows:

With no qualifying child maximum EIC is \$382 and is phased out for income between \$6,240 and \$11,230 (\$7,240 and \$12,230 for married filing jointly).

With 1 qualifying child maximum EIC is \$2,547 and is phased out for income between \$13,730 and \$29,666 (\$14,730 and \$30,666 for married filing jointly).

With 2 or more qualifying children maximum EIC is \$4,204 and is phased out for income between \$13,730 and \$33,692 (\$14,730 and \$34,692 for married filing jointly). Workers who have certain investment income over \$2,600 in 2003 are not eligible for the EIC.

- Long-term care insurance premiums includable as medical care for the itemized medical expense deduction increase to the following dollar limits for 2003:
 - \$250 for those 40 or younger

\$470 for those over 40 but not more than 50
\$940 for those over 50 but not more than 60
\$2,510 for those over 60 but not more than 70
\$3,130 for those over 70

- Maximum amount an employer can exclude from an employee's income in connection with the employee's adoption of a child is \$10,160 in 2003, and effective with 2003, there is no difference in the exclusion amounts for adoption of children with or without "special needs" The exclusion phases out for taxpayers with modified adjusted gross income between \$152,390 and \$192,390.

Comments is an informative publication for our clients and friends of the Firm. It is designed to provide accurate information on the subject matter covered. We recommend you consult with your legal and other advisors to determine if the information is applicable in your specific circumstances. If these advisors are not available to you, please feel free to contact Barry N. Finkelstein, CPA at 972/934-1577 or e-mail at info@facpa.com.