

September 8, 2001

## COMMENTS - SEPTEMBER, 2001

### ADMINISTRATION, SYSTEMS AND EDP

# If you are managing a service business, you are undoubtedly feeling the effects of the slowing economy and seeking ways to trim cost. Some areas which might prove fruitful include:

1. Tracking of billing and collection activities to increase cash flow and minimize bad debts.
2. Gaining control over payroll to prevent any unauthorized overtime.
3. Reviewing employee benefits with a view of renegotiating fees with current benefit providers.
4. Reassessing space requirements to maximize unused space which could be sublet.
5. Conducting communications system audits to determine phone lines and services actually needed and eliminating those which are redundant.
6. Reviewing insurance requirements and comparing costs to minimize outlays.
7. Obtaining vendor proposals and bids for the purpose of lowering costs

# Virus attacks, intrusion by hackers and other types of computer crime are reawakening concerns about systems security. According to a recent survey, managements' key security priorities over the next year are:

1. Enhancement of network security
2. Blocking of unauthorized access
3. Increasing awareness of security procedures among users
4. Web browser security issues
5. Monitoring of user compliance with security measures
6. Introduction of encryption systems

According to the Computer Security Institute and the FBI, their concerns are well founded. In a survey of 643 U.S. companies, 74% acknowledged they had suffered financial losses due to computer systems breaches and the biggest losses stemmed from the theft of proprietary information and from financial fraud. Forty-five percent of the companies also reported over 10 million in losses stemming from the theft of laptop computers. One way companies are fighting computer crime is by having frequent reviews of information security policies and systems. About 25% of firms do this on a continuous basis, another 35% do so at least once a year and the remaining 40% have no regular pattern for reviewing and evaluating information systems security according to an Information Week survey. If you have not had an evaluation of the adequacy of your computer systems security measures within the past two years, your firm may be vulnerable to a

variety of computer crimes and real financial losses which could be prevented through implementation of appropriate protective measures.

## FEDERAL REGULATIONS

# The Gramm-Leach-Bliley Act went into effect July, 2001. It overturns the depression era Glass-Steagall Act which prevented financial institutions from cross-selling banking and insurance services and products, and includes a section known as Title V, which deals with privacy. The privacy provisions apply to "financial institutions" and state they are:

1. Prohibited from disclosing non-public information without authorization.
2. Required to furnish a financial disclosure policy to prospective and current customers.
3. Forbidden to obtain non-public information under false premises.

The term "financial institution" is broadly defined and might even include accountants and others who provide tax planning services, investment advisors and possibly, accountants who perform accounting services which result in providing financial information to banks. Undoubtedly, readers have received disclosure policy statements from banks, brokerage firms and credit card companies which fall under the definition of "financial institutions" and have been given the choice of opting out of the disclosure of non-public personal information. The disclosure policy statement must be provided to existing customers and clients at least once a year and a new disclosure policy statement must be provided each time a new customer or client or an existing one requests a new financial product or service.

## INSURANCE

# In the past few years property insurance premiums have been relatively stable. There was excess capacity in the industry and insurance companies were focused on capturing market share. Often, when they incurred significant underwriting losses, companies offset them by investing premium reserves in the stock market. However, the decline in the stock market and even larger jury awards (up 93% since 1993) have led to extremely poor profit performance for many of the insurers. As a result, investors have put severe pressure on managements to raise insurance premiums to profitable levels. Over the short term, this may result in premium increases of 75% - 100% this year for some insurers. Accordingly, homeowners, business owners and others who require property insurance can expect to see substantial increases when policies are up for renewal. We recommend clients and their brokers comparison shop early, so the best deal can be negotiated.

# In general, if you are self-employed, for tax purposes you are required to treat the cost of health insurance coverage as a personal expense and obtain only a 60% deduction as an adjustment to gross income. Then, the remainder may be taken as an itemized medical expense which is deductible only to the extent it exceeds 7.5% of adjusted gross income. The reality is many small business owners are unable to deduct all of their health insurance costs. However, there is usually a

simple strategy for getting around this problem. If the self-employed individual's spouse is on the payroll he or she can be provided with family health insurance coverage as a fringe benefit. In that event, 100% of the insurance premiums paid by the business would be tax deductible. A word of caution though: the insured spouse should provide legitimate services for the business or the IRS may challenge the deduction as a tax avoidance scheme.

## **LABOR RELATIONS**

# Changes in the moral climate have led to increasing employee theft, and because many companies won't report this type of crime, the full extent of the losses is not known. However, the fact businesses routinely budget 1% to 5% for "inventory shrinkage" gives some idea of the dimensions of the problem. Employee theft can be attributed to lax hiring practices, poor inventory controls and ineffective internal control systems overall. Here, in broad general terms, are some approaches for dealing with a serious problem:

1. Recognize that employee theft is an opportunity crime which can be diminished by altering the risk/reward ratio.
2. Initiate thorough employment screening, including background and reference checks.
3. Establish strict inventory control procedures which are supported by regular physical inventories and by independent checks of inventory counts.
4. Initiate inspection procedures of bags, lunch boxes, lockers and other items which may be utilized in order to perpetrate a theft of company property.
5. Utilize your CPA firm to review internal control systems and to suggest procedures for enhancing control over merchandise, equipment and other assets.
6. Communicate to workers that employee theft is a shared problem which could impact on their jobs.
7. Investigate all suspicions of larceny thoroughly, and prosecute if you can identify the perpetrator.

## **MARKETING**

# Although direct mail results in a higher response rate to customer solicitations than e-mail, the latter is probably the more cost-effective marketing tool. This conclusion is supported by a recent analysis of solicitations to 1,000 existing customers. Of those who were made aware of a sale by direct mail 3.9% actually made purchases. Among those who were solicited via e-mail, the purchase rate was only 2.5%. However, mailing cost per sale was \$18 for direct mail and only \$2 for e-mail.

## **MONEY, BANKING AND CREDIT**

# It's not uncommon for a closely-held corporation to lend money to one or more of its shareholders. While there is nothing illegal about the practice, the IRS will carefully scrutinize the transaction to determine whether it was really a loan or

merely a disguised dividend. In the final analysis, "intent" is the determinant, but this is a subjective criterion. Therefore, the courts have established a number of objective criteria for assessing "intent." Key factors include:

1. Control of the company by the borrower.
2. Dividend paying history of the company.
3. Amount of loans and frequency with which they are made to the borrower.
4. Adequacy of underlying documentation, including existence of an underlying promissory note and a maturity date for the loan.
5. Use of a reasonable rate of interest on the loan.
6. Collateral provided by the borrower to secure the loan.
7. Ability of the borrower to make the loan repayments.

In effect, the IRS and the courts look at shareholder loans the same way they would look at loans to outsiders to determine whether the arrangement has the attributes of a loan, or whether it really represents a disguised dividend.

## **PENSION AND ESTATE PLANNING**

- # If you have life insurance or a pension plan through a private employer, make sure your beneficiary designations are current and reflect your wishes. This warning is the outgrowth of a Supreme Court ruling involving a man who died in an automobile accident just two months after he and his wife were divorced. He did not have a will, and the ex-spouse was still designated beneficiary of his pension and life insurance benefits. The couple had resided in Washington, where state law revokes a spouse's beneficiary designation upon divorce. So the children sued to recover the \$46,000 of life insurance benefits paid out to the ex-wife. While the lower court ruled for the ex-wife, an appeals court and the Washington Supreme Court held the children were entitled to the benefits. But the U.S. Supreme Court, by a vote of 7-2, declared the Employee Retirement Income Security Act (ERISA) overrides state law when state law conflicts with the ERISA requirement that benefits be paid exactly as the employee indicated in legal documents. In effect, the former wife was awarded the proceeds. Although this type of problem tends to be prevalent most often when there has been a divorce, remarriage, death of a spouse or the birth of a child or grandchild, insurance policies, pension benefit documents and wills and other important papers should be examined annually to be sure that pension beneficiaries are appropriate. You should have an annual review of your personal finances, retirement or estate planning as well as a review of your beneficiary designations.
- # If you converted a traditional IRA to a Roth IRA early last year, the poor stock market performance might make you want to convert back. You have until October 15<sup>th</sup> to recharacterize the Roth IRA even if you have already filed your tax return for 2000. Recharacterization makes sense if you did the conversion before the stock market break and paid high taxes based on the inflated stock prices at the time and now find that you have a depleted portfolio. If you have filed your tax return for 2000, you'll have to recharacterize and file an amended return to reflect the change. If you have received extensions and have not yet filed your

year 2000 return, you'll just need to recharacterize and recalculate the taxes due, eliminating the taxes owed on the conversion to the Roth IRA.

## PERSONAL FINANCIAL PLANNING

# The typical family has over \$8,000 in credit card debt besides outstanding loans, mortgages and other financial obligations. Most people get into this mess gradually. But when the economy turns sour, the problem may become very serious. To develop fiscal responsibility, we recommend:

1. Identifying situations where you lack financial discipline. Common examples include excessive catalog purchasing, impulse buying at supermarkets and excessive long distance calling.
2. Establishing a monthly budget by analyzing income sources and listing expenditures as necessary and discretionary. Then track all expenses and cut back on discretionary expenditures until significant portions of debt are repaid.
3. Eliminating the use of credit cards and paying cash for all purchases. It's estimated consumers who do not use credit cards spend 30% less per month than those who do.
4. Setting aside a fund incrementally, to provide for outlays which occur irregularly, such as repairs, appliance replacements, insurance premiums and vacations so you need not borrow when these items have to be paid for.
5. Tracking credit card balances weekly to heighten awareness of the debt and also to establish a habit of reducing this costliest type of debt.
6. Minimizing restaurant meals. Over 50% of food budgets are spent going to restaurants instead of preparing and having meals at home.

Unfortunately, for most people, the result of trying to cure the excessive debt syndrome is as difficult as dieting. That's why many people need the intervention of an intermediary.

## REAL ESTATE

# Electric utility deregulation has already occurred in California, Massachusetts, New Jersey, New York and Rhode Island and will be completed in at least 10 other states by the end of the year 2002. Even though it has gone smoothly in most states, the California experience gives an inkling of how it can go wrong. Therefore, if you are a property owner or manager, you should begin shopping around for a reliable energy provider who will furnish needed service at a competitive cost. Here are some suggestions for proceeding:

1. Obtain your current account and meter numbers and the rates your local utility is charging and ask the utility for a list of energy suppliers in your area.
2. Determine whether the names provided are approved by your state's regulatory commission and can supply required service to all your facilities.

Before signing any contract, determine:

1. There is no language that enables the utility to interrupt service without a penalty and without a lock-up provision.
2. The company can satisfy all of your energy requirements.
3. There are no restrictions on your energy consumption.
4. There are no balancing charges, no excessive late payment charges and no other hidden costs.
5. The provider will charge a fixed price or provide guaranteed savings if flexible pricing is used in the contract.

If you decide to change energy suppliers you should also obtain a refund of deposits the old provider is holding. Remember energy is a commodity and your costs should diminish with increases in volume. For information about energy deregulation, you can call Metromedia at (800) 828-9427 or visit their web site at [www.metromediaenergy.com](http://www.metromediaenergy.com).

## TAXATION

# Katia Popoc, is a professional violinist who performs with an orchestra and also records music. She recorded in 38 different locations without advance receipt of required sheet music. Since none of the employers provided her with a place to practice, she used the living room of her one-bedroom apartment as a practice area four to five hours per day, and also, to make recordings. On her 1993 tax return she claimed a home office deduction for the living room. Both the IRS and the Tax Court denied her claim. But the Court of Appeals for the 9th Circuit agreed the deduction was valid. It concluded the violinist spent considerably more time practicing her violin at home than she did performing and recording. Therefore, the apartment living room was her principal place of business which she used exclusively for that purpose. The decision may make it easier for other musicians and artists to obtain an office at home deduction.

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