October 1, 2002

COMMENTS - OCTOBER, 2002

ACCOUNTING AND AUDITING

Clients frequently question us about the advantages of establishing a subsidiary company. Although in most instances we find no compelling reasons for establishing a subsidiary, there could be exceptional circumstances, such as:

- Possible litigation that could result in significant liability.
- Desirability of segregating products or business to enhance the company's credit rating and obtain bank financing.
- Tentative plans to sell a portion of the business.
- Need to divide a business between several family members.
- Possible government-related economic benefits based on such criteria as minority ownership.
- Federal or state tax benefits derived from locating part of a business in a separate state or country.
- Marketing considerations associated with enhanced product identification.

INSURANCE

As people age, life insurance needs change. Key factors that affect life insurance needs include marriage, birth of children, taking on debt such as a mortgage on a home, need to provide for a child's education, maturing of children, return of a spouse to the labor force and estate planning needs. If you are in a situation where life insurance needs are diminishing, such as when children are grown and no longer dependent or when a home has been fully paid off, retention of the insurance may no longer provide a worthwhile benefit. If the insurance is an ordinary life insurance policy which has built up a significant cash value rather than cashing in the policy, you may be able to obtain a more satisfactory benefit by donating the policy to a charity. Here, the charity would ultimately obtain the insurance proceeds upon your death. Meanwhile, you would be able to obtain a charitable contribution deduction for the policy's cash value. Furthermore, if you continue to provide the charitable organization with funds to pay policy premiums, these would also be deductible each year. Here is just one financial and tax planning idea for utilizing insurance you have outgrown in a personally gratifying manner.

MONEY, BANKING AND CREDIT

If you are a bank customer with a savings or checking account, you probably have been solicited about engaging in on-line banking. While speed, convenience and the ability to transact around the clock are definite enticements, we suggest

readers move cautiously. Possible pitfalls include:

- Enticement of a free-checking account to get you to participate followed by fees in a year or less.
- Systems security problems if you do not have adequate firewall protection for your computer.
- Inability to access funds periodically if systems need to be upgraded because of mergers.
- Solicitation for a variety of unneeded "for fee" services such as bill payment, which can become a nuisance.
- Inadequacy of FDIC insurance protection. If the Internet subsidiary is not a separately chartered bank, the deposits at the Internet branch and parent bank would be <u>combined</u> to determine adequacy of insurance protection even if the banks have different names.

You also need to be aware of phony on-line schemers which utilize web addresses similar but not identical to legitimate banks to obtain money or information to be used for identity theft and other illicit purposes. They will often seek social security numbers, bank account numbers and other data from legitimate on-line banks' customers. If you still find the features of on-line banking to be a plus, we recommend you evaluate the solicitations carefully, assess your needs and the potential benefits, and proceed with caution because you will be entering a medium which is largely uncontrolled.

Watch out for ads that say "no payment on merchandise until next year". While it is true you will not need to make payments for a number of months, it does not mean you are being given an interest-free loan. The vendors will usually add in interest from the date of your purchase, so, when the payments begin, you will be paying considerably more for the merchandise than you had figured on. Consumer credit can be very tricky, and sharp merchants will often provide enticements which make you believe you are getting a financing break.

PENSION AND ESTATE PLANNING

Last year, Congress passed the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) which included provisions designed to enable employees to build their retirement savings and lower their taxes by increasing the amounts they can contribute to or defer in employer-sponsored retirement plans such as 401(k), 403(b), and 457(b) plans, and IRA’s. Unfortunately, as of late April over a dozen states have failed to modify their tax laws to give effect to the changes, so employees would be subject to state income taxes on the additional contributions which are now permitted under Federal law as well as to possible penalties or disqualification of the pension plan. States which had not changed their laws to conform to the EGTRRA provisions included: Alabama, Arizona, Arkansas, California, Georgia, Hawaii, Kentucky, Maine, Massachusetts, New Jersey, North Carolina, Pennsylvania, South Carolina and Wisconsin. Since the intent of state legislatures in some of these jurisdiction is to conform their laws to Federal contribution limits, while in other states, they are reluctant to do so because of

budget shortfalls, residents should contact their tax advisors to assess the status.

Many retirees invest in bonds to supplement other sources of retirement income and hope they will not outlive the income and principal they must withdraw to meet their living costs. For peace of mind, an alternate approach, utilizing an immediate annuity may be more desirable. This type of annuity provides a larger payout than the bond interest from government bonds because it also pays out a portion of the principal invested. Furthermore, the payments are guaranteed for life so the annuitant will never run out of income. Of course, the trade-off is there will not be any principal remaining after the annuitant dies. Also, there is no protection against inflation, and the annuity is irrevocable in that, unlike bonds, it can not be sold after the annuitant dies. Some people compensate for these disadvantages by buying an annuity with a term-certain provision which guarantees pay-outs for a specified number of years even if the annuitant dies shortly after purchasing the annuity contract. Also, some retirees stagger the terms of their annuities or purchase additional annuities at 5-year intervals to offset the inflation concerns, since the older the retiree is at the time of purchase of the annuity, the greater will be the pay-outs because of the shortened life span. However, before investing in an annuity, factors which must be weighed include the amount of the annual payout, fees charged by the insurance company and credit risk of the insurer which provides the annuity.

PERSONAL FINANCIAL PLANNING

What happens if you own a mutual fund, and the sponsor terminates the fund because it loses money due to a huge decline in the value of the fund's holdings? A fund liquidation is no different from your sale of the shares. Thus, if the fund lost money from the time you made the investment you would be able to reflect the loss on your return. Alternatively, the sponsor may fold the fund into another more successful fund. This kind of merger is not a taxable event. Of course, if you are unhappy with the fund into which your investment has been transferred, you can sell your shares in the new fund and reflect the loss.

Here are seven powerful warning signs you have a serious financial problem.

- Using more than 20% of net income to pay credit card and other loans.
- Obtaining new loans to pay loans you already have.
- Approaching or exceeding the limit of your credit card line.
- Paying only the minimum balance allowed on your credit card statement.
- Paying bills late.
- Deferring necessities such as doctor's visits.
- Working at a second job to cover necessities of daily living such as food.

Many people have saved for a child or grandchild's college education by establishing a Uniform Gift to Minors Account (UGMA). However, in recent years, the IRS and the financial industry have come up with a number of more desirable college education funding vehicles. Probably, the best of these is a Section 529 College Savings Plan. Therefore, we are frequently asked if the UGMA money can

be transferred into a section 529 plan. While Federal law permits the transfer, legal details governing UGMA accounts and section 529 plans are governed by state law. Thus, you need to obtain advice from a reliable source in your state to determine whether this kind of transfer is permissible. However, even if such transfers are allowed, they may not be desirable, because if the UGMA account has unrealized gains there may be significant adverse tax consequences. Instead of making a transfer, it might be more advisable to retain the UGMA account and make any future contributions into a section 529 plan. Among the principal benefits of section 529 plans are tax deferred savings; tax-free withdrawal of accumulations for qualified education related expenses, and in some states, state tax deductions for contributions.

TAXATION

The Job Creation and Workers Assistance Act of 2002, contains a number of provisions which may provide tax relief for individuals and business. Among these:

- Extension to 2002 and 2003, of rules allowing personal tax credits to be used to offset regular income tax and the Alternative Minimum Tax.
- Modification of the definition of "foster care payments" which may increase the amount taxpayers can exclude from income.
- Extension to 2003, of the expiration of Archer Medical Savings Accounts.
- A write-off for 2002 and 2003 of up to $250 per year for elementary and secondary school teachers who spend their own money on classroom supplies and equipment and meet a 900 hour minimum work requirement.
- An additional 30% first-year depreciation deduction for property acquired after September 10, 2001, and before September 11, 2004, and placed in service before January 1, 2005.
- Increased first-year depreciation write-offs for luxury cars (cost of $17,409 or more) placed in service after September 10, 2001, and before September 11, 2004.
- Carry back of net operating losses arising in tax years 2001 and 2002 for five years instead of two years.
- Provisions to permit electronic transmission of information returns (Forms 1099) to taxpayers who consent to receive them electronically.
- Extension of various tax credit which were to expire in 2001, including the work opportunity credit; the welfare-to-work credit and various energy credits.

The IRS has announced the over and underpayment interest rates for the third calendar quarter will remain unchanged from the second quarter. Thus, they will stay at 6% for over and under payments except for: rates of 5% on corporate overpayments, 8% on large corporate under payments and 3.5% for the portion of a corporate overpayments which exceeds $10,000.