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COMMENTS - NOVEMBER, 2002

ADMINISTRATION, SYSTEMS AND EDP

The events of the past year have highlighted the need for backing up data to enable a business to survive both natural and man-made disasters. In developing a back-up system, you should begin with two fundamental considerations. They are: (1) the length of time needed to recover data before operations are seriously impacted, and (2) the cost of developing and implementing a data backup system. The simplest systems are to back-up data on a regular basis onto magnetic tape, disk or CD and store it off premises, or to use electronic vaulting whereby critical business data is sent over the internet in real time, to the home computer of a key employee or to a company which provides storage space on its remote computer. Alternatively, some businesses invest in redundant computer hardware which functions as a backup device in the event a system component fails, so interruption of business operations is completely avoided. This approach is quite costly and usually only suited for very large business organizations.

PENSION AND ESTATE PLANNING

The Economic Growth and Tax Relief Act enables self-employed individuals, as well as corporate owners to receive larger tax deductible contributions under a profit-sharing 401(k) plan than under profit sharing and money purchase pension plans. The legislation permits plan sponsors to deduct employee 401(k) elective deferrals up to $11,000 in 2002 in addition to the employer contributions, and it increases the profit-sharing 401(k) plan deduction limit for employer contributions to the lesser of $40,000 or 25% of compensation up to $200,000. In effect, since the maximum annual addition, and hence, the deductible employer contribution in 2002 is $40,000, self-employed individuals and corporate owners have annual self-employment and W-2 income of $160,000 or more may receive a $40,000 deductible contribution under either a profit-sharing, or a money purchase plan, and can set aside an additional $11,000 under a profit-sharing 401(k) plan. However when compensation is less than $160,000, the profit-sharing 401(k) plan provides for significantly greater percentage contribution deductions enable a self-employed individual or corporate owner to deduct more than 25% of compensation. For example, if an individual earns $100,000, he or she may deduct $25,000 under either a profit-sharing or a money purchase plan, but with a profit sharing 401(k) plan, the allowable deduction increases to $36,000 (the $25,000 employer contribution and the $11,000 401(k) deferral for 2002), for a total contribution of 36% of compensation. Furthermore, if the individual is over age 50, he or she would also be eligible for a catch-up contribution in the amount of $1,000, raising the maximum contribution to a profit-sharing 401(k) plan to $37,000, or a maximum contribution equal to 37% of compensation in 2002. Moreover, since the catch-up contributions increase by $1,000 per year until they reach $5,000 in 2006, and since 401(k) contribution limits increase to $15,000 by 2006, an even greater percentage of compensation will be able to be set aside as tax deductible contributions to a profit-sharing 401(k) plan by self-employed individuals and corporate owners. The pension related changes contained in the Economic Growth and Tax Relief Act provide for significantly more liberal pension set asides and need to be discussed at length by self-employed individuals and corporate owners and their tax

advisors.

The IRS has issued final regulations governing the required minimum distributions from IRAs and other qualified plans which participants must take by April 1st of the year after they reach age 70 ½. The final rules contain a life expectancy table which is even more generous than contained in prior proposed regulations and reflect the fact that people are living longer. In turn, minimum distributions can be decreased because they are spread over a greater number of years. For example, a 75-year old with a $500,000 account balance would be required to take a distribution of $21,834 in 2002, compared to $22,936 under the earlier tables. Use of the latest table is optional for 2002, but is required for 2003. Pension plan trustees will also be required to provide IRA owners with a report about the minimum distribution requirement by January 31, 2003, and will also be required to report to the IRS on Form 5498, beginning in 2004, to enable the Agency to cross-check whether an individual taking a distribution is also reporting it on his or her tax return. The regulations also require qualified retirement plans to be amended by the end of the first plan year starting on or after January 1, 2003, to comply with the new regulations. The final regulations simplify rules for when an account of an IRA owner or employee is divided into separate accounts to accommodate multiple designated beneficiaries. They also provide rules with respect to the calculation of each year's required minimum distribution from an IRA or a separate account under a qualified plan, and extend the 50% penalty for people who fail to take their required distributions to cover people who inherit Roth IRAs. Finally, the regulations establish September 30th of the year following the year of an account owner's death as the date for determining the designated beneficiary of the account for required minimum distribution purposes.

Here are some steps to consider if you intend to establish a 401(k) plan. They should serve you well in maximizing participation, and also for avoiding disputes, unsatisfactory labor relations or potential litigation if the plan's performance fails to live up to the expectations of participants.

- Permit plan participants to make daily changes to their plan over the Internet via an 800 number.
- Consider providing some kind of employer matching of employee contributions to encourage participation. Most firms match 50 cents per dollar, or about 3.3% of payroll.
- Limit investment options to no more than 10 possibilities. The average number now is 11.5.
- Do not provide investment advice, but let participants obtain it from an independent advisor.
- Thoroughly document any changes you make in investment advisors.
- Furnish participants with the employer's objectives in providing the plan.
- Obtain an ERISA compliance audit from an attorney or CPA who specializes in this area.

- Select a group of responsible and trusted employees, including plan participants, to be trustees of the plan.

- Provide financial seminars to help participants cope with investment decisions they have to make.

PERSONAL FINANCIAL PLANNING

Here are series of situations common in divorce, which lend themselves to tax planning. Strategies which minimize the tax cost of these decisions can often minimize the financial burden of the marital dissolution, and allow for a more favorable settlement for all concerned. Many people foolishly underestimate the economic importance of expert advice and fail to obtain the professional assistance which is required to deal with the tax issues.

- Proper allocation between alimony and child support payments.

- Paying expenses on behalf of a former spouse rather than to the person.

- Utilization of advantageous tax strategies in the planning of property settlements.

- Utilization of "head of household" tax status by a spouse who has not lived with the other spouse for at least 6 months and has a dependent child living at home.

- Shifting the dependency exemption to the non-custodial parent.

- Taking a medical payment deduction on behalf of children even though the other spouse claims the dependency exemption.

- Placing ownership of life insurance on the ex-spouse's life, which is part of the divorce arrangement, with the non-insured spouse.

If you own a family business, there are many tax planning possibilities which will enable you to reduce income taxes and retain more of your hard earned money. Here are some examples:

- New retirement plan options let you set aside more money annually in qualified retirement plans.

- If your businesses uses real estate or costly equipment, taxes can often be saved if these assets are owned separately by a family member rather than by the business, and leased back to your firm.

- Organizing the business as a pass-through entity (S corporation, limited liability company or limited partnership) creates tax advantages including avoidance of double taxation of income, income shifting by giving family members an equity interest in the business and loss shifting which enables an owner to deduct losses in the early years against ordinary income.

- Hiring children to shift income from high- to low-tax bracket family members.

- Making gifts of equity interests in the business to family members on a tax-favored basis because minority interests in a business are usually valued at a discount from their market value.

REAL ESTATE

IRA owners can withdraw up to $10,000 from an IRA penalty-free for the "first time" purchase or construction of a home for themselves, or a child or grandchild, provided the funds are spent within 120 days after withdrawal. Now, the IRS says people who had owned a house earlier are also entitled to this break as long as they or their spouses did not own a home in the preceding two years.

You may want to consider some of the tax consequences of buying and renting out a vacation home. Here, in general, is a brief summary:

- You may deduct interest up to $1 million on acquisition debt to buy a second home. Alternatively, if you take out a home equity loan on your primary home to buy the vacation home, interest is deductible on up to $100,000 of home equity debt. Also, real estate taxes on vacation homes are fully deductible.

- If you rent out your vacation home for fewer than 15 days a year, the rental income is tax-free regardless of personal use you make of the home. However, you may not deduct any of the rental related expenses aside from the mortgage interest and real estate tax deductions.

- If personal use of the vacation home by you and family members exceeds the greater of 14 days or 10% of the number of days the home is rented during the year, the income has to be reported, but this may be offset with deductions for interest, taxes, maintenance costs and depreciation up to the extent of the rental income.

- If personal use is less than the greater of 14 days or 10% of the rental days. rental expense deductions are not necessarily limited to rental income, but are governed by passive activity loss rules. Under these rules, losses in excess of passive activity income are limited to $25,000, and this is reduced once adjusted gross income exceeds $100,000 and fully phased-out once adjusted gross income exceeds $150,000.

TAXATION

In light of new tax changes which took effect this year, as well as to review significant transactions with tax consequences, we remind readers it is time for a tax check-up. This will help you and us to take advantage of tax saving opportunities and to devise strategies for lowering this year's taxes. To help you, we've compiled a brief summary of tax changes which took effect in 2002. They include:

- Changes in tax rates, deductions and personal exemptions.

- Modification of the itemized deduction phase out limits.

- Revision of the excise tax on luxury automobiles.
- Increases in IRA contribution limits and expansion of rollover options.
- Increases in elective deferrals for 401(k), 403(b) and salary reduction SEPs.
- Increases in defined contribution plan and pension plan contribution limits.
- Establishment of a new retirement savings credit for lower income taxpayers.
- Increases in student loan interest deductions and establishment of a new college tuition deduction.
- Enhanced tax benefits with respect to Section 529 qualified tuition plans.
- Increases in the gift tax annual exclusion and lifetime exemption.
- Increases in the maximum estate tax rate and exemption.

Good tax planning requires a long range focus which extends beyond the current year, and now is an ideal time to take a snapshot of your tax picture and to devise the strategies which will provide long-term benefits.

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.