

## **COMMENTS - MAY, 2004**

### **ACCOUNTING AND AUDITING**

- The Association of Certified Fraud Examiners reports that travel and entertainment expense reporting fraud is occurring more frequently and growing in dollar amount. Common methods of perpetrating this type of fraud include:
  - < Mischaracterizing expenses which are personal as being business related
  - < Overstating the actual cost of business expenses when seeking reimbursement
  - < Including totally fictitious expenses on expenses reports
  - < Seeking multiple reimbursement for the same expense by including it on several expense reports

A simple way of avoiding expense reporting fraud is to have an independent review of your firm's expense reporting practices and procedures by your CPA firm. Many clients have found that the outlay for an expense reporting systems review is recovered many times over as a result of tighter controls and enhanced deterrence.

- Concern about the unreliability of earnings being reported and projected has induced many potential investors and credit grantors to give more weight to cash flow projections in their decisions about investing and granting credit. Unfortunately, a recent survey of large companies reveals 75% have no confidence in the accuracy of their own cash flow forecasts. Reasons include:
  - < Lack of systems integration among different business units.
  - < Inadequate internal communications.
  - < Erroneous sales projections.
  - < Inadequate collection policies and practices.
  - < Problems with pricing, billing and logistics.

Fortunately, these problems are generally not prevalent when it comes to smaller organizations.

### **ADMINISTRATION, SYSTEMS AND EDP**

- Increases in technology spending are encouraging information technology software vendors to raise their prices after having had a number of years of declining revenue. Unfortunately, purchasers have only limited ways to protect themselves against these price hikes. Here, however, are some suggestions that might minimize the cost increases:
  - < Require your vendors to bundle the price of software and services to avoid being hit with lots of costly add-ons each time you make a purchase

- < Reduce the number of software vendors with whom you deal and build a closer relationship with just a few vendors
- < Include escalation clauses in your contracts to limit future price hikes when vendors update software, especially if the updates have little value for your firm
- < Many experts believe software developers are entering into a long-term sellers market, so it is important for you to act in a timely manner to keep costs under control.
- Did you know there were a record 76,000 attacks on computer systems globally during the first 6 months of 2003 compared to about 82,000 for all of 2002? The average direct cost of each information technology security breach amounted to \$108,000. This is excluding down time and productivity losses in getting the system secured and restarted. According to surveys of computer systems breaches, 34% of the attacks come from independent hackers, 21% originate with current or former employees, 4% are initiated by competitors and 3% are undertaken by customers. Although there is much sophisticated technology around to help businesses secure their computer systems, paying careful attention to some basics may be even more effective in protecting your firm from computer crime. Some examples:
  - < Require the use of alpha-numeric passwords of at least eight letters and numbers
  - < Establish a policy of changing passwords at least every 90 days
  - < Update virus protection software on a regular basis
  - < Implement complete network security reviews on a regular recurring schedule
  - < Immediately remove network access when people leave your employment
  - < Utilize a secure, centrally managed server if employees require remote access to your computer system
- Businesses which try to sell their personal computers after 3 years of ownership receive only about 3% to 5% of the original equipment price for the machines. Yet they will incur between \$85 and \$136 in disposal costs just to get rid of the equipment, making sale of used computers a losing proposition. Therefore, many experts recommend:
  - < Giving used equipment to workers to enhance the employer/employee relationship and to encourage workers to become more computer literate
  - < Auctioning off the equipment to the highest bidder by using a Web site such as e-Bay
  - < Donating the computers to a local non-profit organization which can utilize them

Many people think the third choice makes the most sense since it may garner some favorable publicity for the firm and also enables it to reduce taxes in connection with the contribution.

- Some computer vendors are providing discounts for doctors and other medical care providers to encourage them to adopt electronic medical records systems. While the

special pricing is an inducement, there are more important issues. The establishment of these systems enables doctors to share medical records, which may be needed for patient treatment, with other physicians the patient uses as well as with hospitals in distant locations. Sharing of information could also avoid treatment and medication errors. Patient data usually included in a medical records system includes:

- < Patient identifying information such as the name and address of the patient, etc
- < Insurance and financial information (eligibility, co-payments, etc.)
- < Patient health status (diagnosis, problems, conditions, adverse reactions, current medications, immunizations, lab results, etc.)
- < Care documentation (information about disease management and specific health care institutions being utilized)
- < Care plan recommendations (scheduled tests or regimens of care)

Today, doctors need no longer worry about inadequate computer security which might compromise a patient's privacy, because technological advances in this area have largely eliminated this concern.

## **FEDERAL REGULATIONS**

- The recent Medicare legislation provides for a new type of "health savings account" (HSAs) beginning in 2004 to replace the old "medical savings accounts" (MSAs) and pay for medical costs using pre-tax dollars. The HSAs will be available to more taxpayers since there is no cap on the number of accounts which may be established, and they can be established by employers as well as individuals. Here are the major highlights of the new HSA accounts:
  - < Only people with high deductible medical insurance can set them up. The minimum allowable deductible is \$2,000 for family coverage and \$1,000 for individual coverage. Annual out-of-pocket expenses (deductibles, co-payments, etc.) to be paid under the plan cannot exceed \$10,000 a year for family coverage or \$5,000 for individual coverage.
  - < HSA owners are not permitted to have basic health insurance or be eligible for Medicare, since the accounts are intended to be used by people who lack basic insurance. However, the accounts may be set up to provide disability, dental, vision and long-term care insurance.
  - < Individuals under age 65, employees or family member will be able to make pre-tax HSA contributions equal to the deductible on the associated insurance policy. Annual contributions to HSAs are limited to a maximum of \$5,150 for family coverage and \$2,600 for individual coverage, and the contributions may be made using salary reduction. (In 2004, individuals who were born before 1950 can contribute an extra \$500.) Balances in MSA accounts may also be rolled over into

HSA accounts tax-free.

- < Income earned by the funds contributed to the HSA is not taxable to the account owner, and withdrawals made to pay medical bills are not taxed if the bills are for medical treatment of someone covered by a high deductible plan. Payouts for other purposes are taxed and subject to a 10% penalty unless made after attainment of age 65, or due to death or disability.
- < Unused amounts in an HSA may be carried forward to the following year.
- < Pay-ins to HSA accounts are fully deductible by employers which make them on behalf of employees who lack basic medical insurance coverage, and they are not taxable to the employees. However, employers offering HSAs are required to provide them for all eligible workers.
- New Labor Department regulations will require labor organizations to disclose more details about their finances, including their expenditures on lobbying, politics and administration. The rules apply to unions with \$250,000 or more in annual receipts and will require them to itemize certain receipts and disbursements of \$5,000 or more as well as disclose information about trusts and other funds with receipts exceeding \$250,000 in which they have an interest. The new requirements are effective for financial reports beginning on or after January 1, 2004.

## **INSURANCE**

- Employers need to be aware their unemployment insurance costs are likely to rise significantly in 2004. Most state treasuries have been depleted by payouts of high unemployment insurance claims stemming from the 6% unemployment rate for the past two years. As a result, over 30 states have indicated they will be hiking their insurance rates this year. Biggest increases will be in Arkansas, California, Colorado, Florida, Georgia, Illinois, Minnesota, Ohio, Oklahoma and Pennsylvania, where premiums are expected to rise 20% or more.
- Having a driver in the family who is under 25 will usually result in a huge increase in your automobile insurance costs. However, you should be aware there are some insurers who offer a discount if the youngster is a student and maintains a B average or better. Discounts may be between 10% and 25% depending on the insurer, and a copy of the student's scholastic record will have to be submitted each year. Alternatively, to lower costs, consider giving the youngster an older car and letting him or her take out insurance. Since insurers consider older, less expensive cars as lower risk, insurance rates tend to be low, and additional savings may be obtained because the amount of collision and comprehensive insurance needed will be low. In effect, savings in overall automobile insurance costs may be possible by keeping the individual off the family's policy as a driver of other family cars.
- Why not switch your old life insurance policy to a new one with better features? While there may be legitimate reasons for making a change, there are a number of pitfalls of which you should be aware. In all likelihood your premiums will rise considerably because: (1) you are older; (2) your health may be impaired, and (3) your

agent will likely include a charge for a new commission. Furthermore, with many new policies the two-year "contestability" period starts running again. This enables a company to deny payment of insurance proceeds if the insured dies within two years after purchasing a policy on the grounds the insured misrepresented his or her health on the application form. Also, the switch in policies could result in reinstatement of surrender charges. These are penalties an insurer imposes upon cancellation of a policy within the first 7 to 10 years after a policy is taken out. Finally, an exchange of policies can also trigger taxes had been deferred. Of course, in spite of these dangers, there may be perfectly good reasons why a change has to be made. For example, you might want to switch to a financially stronger insurance company; you may want to enhance the build-up of cash value on a whole-life policy; you may need to modify a policy associated with a revocable trust because the trust terms are being changed, or the change may be needed with respect to key-person insurance by a business because the executive is no longer with the company. We strongly recommend that before any changes in life insurance contracts are made, review the contracts thoroughly to avoid adverse consequences.

## **LABOR RELATIONS**

- The IRS has released new simplified per diem rates taxpayers can use to reimburse employees for lodging, meals and incidental expenses incurred during business travel without the need to produce receipts. The new rates apply to travel on or after November 1, 2003, and are slightly higher than the rates for the prior year. Thus, the simplified "high-low" per diems have risen to \$207 and \$126, respectively, from \$204 and \$125. The incidental expense per diem was also increased to \$3 from \$2. There have also been changes in locations deemed "high-cost" areas. Employers who have an accountable plan arrangement and who do not wish to maintain records of actual expenses may utilize either the simplified high-low per diem rates or the more detailed Government Service Administration rates in reimbursing employees for travel and substantiating travel expenses. When the per diem rates are used, the employee recognizes no income or employment tax withholding when reimbursed, and the employer obtains the travel expense deduction under the per diem rates, subject to an adjustment for the 50% cap on business meal deductions. Employees who do not have an accountable plan, or self-employed individuals, are allowed a business expense deduction for travel pursuant to the General Service Administration rates, but may not use the "high-low" rates.
- Many companies are unable to provide additional company-paid fringe benefits to employees. As an alternative, however, some decide to provide voluntary benefits which the employee pays for. The employee received a benefit because the cost is usually lower on a group basis than if the employee tried to obtain the benefit on an individual basis. Benefits that are most frequently included among voluntary benefits are:
  - < Optional term life insurance
  - < Long-term care insurance
  - < Critical illness insurance
  - < Travel accident insurance
  - < Auto insurance

- < Group legal services
- < Homeowners insurance

The use of voluntary benefits can be a morale builder for workers at companies that are unable to provide more company-paid benefits.

- The 1990s was a decade which will long be remembered for its excesses as well as the financial demise with which it ended. CEOs were among the prime beneficiaries, with average pay increases of 571% over the period. By comparison, the average worker's pay over the decade rose only 37%, barely outpacing the 32% inflation rate. Had the minimum wage increased at the same rate as executive compensation, the rate which was \$3.80 in 1990, would have risen to \$25.50 by the end of the decade. In light of this, the IRS has decided to target executive compensation in corporate and individual audits. Particular attention is being paid to special fringe benefits for executives, stock options, transfers of assets to family limited partnerships, split dollar life insurance arrangements, deductions taken for salaries over \$1 million and non-qualified deferred compensation arrangements. The IRS agents are looking for compliance with income and payroll tax regulations regarding these types of executive pay transactions. The Agency is also trying to make an overall assessment about non-compliance with the tax law in these areas.

## **MARKETING**

- Business marketers continue to see the Internet as a viable medium for marketing. During the third quarter of 2003, spending on Internet ads reached almost \$1.75 billion, according to the Interactive Advertising Bureau, up 20% over the third quarter 2002. If you haven't viewed the Internet as a marketing arena, you might want to consider its possible use in your marketing strategy.
- Online sales are increasing much more rapidly than sales at brick and mortar establishments, a sign that many people have overcome their fear about making purchases over the Internet. Recent data, covering the third quarter of 2003 shows that:
  - < 62% of Internet users make daily purchases online
  - < Over 50% of online customers spent more than \$250 during the period in making online purchases
  - < 85% of households with incomes under \$35,000 and 92% of households with higher incomes made online purchases during the quarter

Retailers who fail to set up a Web site are missing a unique opportunity to expand their business based on data predicting a huge increase in commercial Internet traffic.

## **MONEY, BANKING AND CREDIT**

- If you turn over an account to the collection agency, the Internal Revenue Code lets you immediately deduct the commission you agreed to, based on the assumption that there will be a full recovery. Deduction of the balance of the loss on the

receivable, however, has to be deferred until the collection agency ceases its collection activity and the remaining debt is deemed to be uncollectible.

- Business owners and individuals will soon see their cash float time reduced on both checks they write and those they receive. It's because the "Check Truncation Act" was recently signed into law. The Act, also known as Check 21, allows banks to substitute electronic check images instead of the actual checks for check clearing purposes. It's estimated the change will reduce check processing time of banks by about 4 days as well as lower the processing cost. Large banks have pretty much geared up for the change and have the check imaging technology in place. Small banks, on the other hand, may take some time before they convert to electronic imaging technology. Of course, small banks with close relationships to larger institutions might piggyback on their systems to accelerate their ability to capture the float. We recommend that readers talk with their bankers to determine when the changes will take effect.
- Your credit history is like a photograph of your financial habits and discipline. If it is marred, you are likely to be denied credit, or you'll invariably have to incur higher costs to obtain credit. Now, an analysis of the credit scores of more than 500,000 consumers and 1,700 credit reports maintained by the three major credit bureaus - Experian, Equifax and TransUnion reveals that 29% had differences of at least 50 points in the credit scores being reflected. That's why it is important to guard your credit history carefully and to periodically determine the information it contains is accurate. In general, a credit score of 700 or more is "excellent;" while a score between 600 and 700 is deemed to be "good," reflecting perhaps a few late payments in your credit history; a score between 500 and 600 is deemed to be "poor," indicating a history of payments that were more than 60 days late; and a score below 500 is "bad" and indicates liens against your property because of irresponsible use of credit. Of course, the lower your credit score the higher interest rates will be if you want to obtain a mortgage or another type of loan. The Consumer Credit League offers a booklet, "Credit History: It Tells A Lot About You." It explains the need for building a good credit history, suggests ways of protecting it and explains your rights if you are denied credit. For a copy, send a self-addressed stamped business-size envelope to:

National Consumer League  
1701 K St. NW Ste. 1200  
Washington, DC 20006

Ask for the publication by name.

- The Fair and Accurate Credit Transaction Act of 2003 was enacted recently. It provides some protection for consumers and imposes certain restrictions on credit bureaus which are intended to reduce the possibility for identity theft. Under the new law, consumers can:
  - < Obtain one free credit report per year from each of the three credit bureaus.
  - < Be notified if a merchant reports missed payments to credit bureaus.
  - < Restrict how the credit bureaus share sensitive information with businesses.

The legislation became effective on January 1, 2004, and the free credit reports must

be made available by the credit bureaus within 1 year of enactment. Last year there were 9.9 million victims of identity theft, according to the Federal Trade Commission.

## **PENSION AND ESTATE PLANNING**

- In an unusual Letter Ruling, the IRS has approved a retroactive pension plan amendment designed to lower the amount contributed by a company on behalf of its officers. In general, plan amendments which reduce a participant's accrued benefit are prohibited except if the amendment is necessary due to: (1) substantial business hardship (taxpayer is operating at an economic loss; there is substantial decline in the industry, or it is reasonable to expect the plan to continue only if the amendment is approved) and (2) a waiver of the minimum funding standard is unavailable or inadequate. Here, the company's required contribution for all plan participants was \$32,000, of which \$16,000 was attributable to two participating officers. The IRS considered the facts that the company had reported losses in three of the last four years, that there had been substantial unemployment in the industry, as well as declines in sales and profits in recent years, and that the pension plan would likely survive upon approval of the amendments since the pension obligations would be significantly lowered. Also, there were cost cutting measures in place that would likely make the business profitable in the future. In allowing the amendments to the pension plan, IRS limited it to the two officers but denied any changes with respect to all other pension plan participants. Nevertheless, the ruling shows that the Agency is willing to be flexible with respect to pension modifications when the taxpayer runs into dire economic circumstances.
- There is an approved strategy for leveraging the annual gift tax exclusion. It involves the use of a "zeroed out" GRAT, an annuity trust where the amount the grantor is to receive is structured to equal what was put in, using IRS rates. Here, if the trust assets out-earn the discount rate, the remainder beneficiary receives the extra money free of gift tax. The Tax Court had sanctioned this strategy back in 2002, but the IRS refused to acquiesce in the decision. Now the Agency concedes the Tax Court decision was correct. Taxpayers considering using this approach should be aware, if the grantor dies before all of the payments are made, any remaining assets become part of the estate.
- Since you should plan on living at least 20 years after normal retirement at age 65, it is important to manage pension money in a way that funds won't run out. Unfortunately, we come across numerous situations where people have made unwise decisions which get them into financial trouble at the point in their lives when they have no chance of supplementing what is left of their pension funds. Common errors include:
  - < Not heeding the minimum distribution rules and incurring unnecessary penalties
  - < Withdrawing excessive amounts in the early years of retirement
  - < Failure by eligible individuals to convert to a Roth IRA
  - < Failing to properly diversify a retirement portfolio so there is excessive risk, or insufficient income to replenish funds withdrawn.

Of course, there are other common administrative mistakes such as naming the

wrong beneficiaries and failing to take advantage of rollover possibilities which could extend tax deferral. Since most people are not conversant with all of the retirement planning possibilities, we encourage pension plan participants to seek professional financial and tax planning assistance regardless of how straight-forward they think their planning needs are.

- The IRS has announced various cost-of-living adjustments for pension plans for 2004. Here are the highlights of the changes effective January 1:
  - < The limit on the annual benefit under a defined benefit plan rises from \$160,000 to \$165,000.
  - < The limit for defined contribution plans will increase from \$40,000 to \$41,000.
  - < The amount for determining the maximum account balance in an employee stock ownership plan subject to a five-year distribution period rises from \$810,000 to \$830,000.
  - < The limit on the exclusion for elective deferrals under Section 402(g)(3) of the Internal Revenue Code increases from \$12,000 to \$13,000.
  - < The maximum amount of compensation that can be taken into account when applying contribution limits is increased from \$200,000 to \$205,000.
  - < The maximum deferral limit pertaining to SIMPLE retirement accounts rises from \$8,000 to \$9,000.
  - < Limitations on elective deferrals regarding deferred compensation plans of state and local governments and tax-exempt organizations increases from \$12,000 to \$13,000.
  - < For individuals aged 50 or older who are allowed to make catch-up contributions to a 401(k), 403(b), salary-reduction SEP, or governmental 457 plan, the maximum additional deferral for 2004 goes up to \$3,000 from \$2,000; and the maximum additional deferral to a SIMPLE plan rises to \$1,500 from \$1,000.

The increases were mandated under the Economic Growth and Tax Relief Reconciliation Act of 2001.

- The Social Security Administration has announced the cost-of-living adjustment for 2004. It says living costs rose just 2.1% last year. It means the average increase in social security payments will be just \$19. Unfortunately, social security recipients won't even be able to enjoy this small increase because Medicare premiums are going up 13.5%, or \$7.90 to \$66.60 per month.
- Do you have a policy of not allowing unused vacation pay to be carried over into the subsequent year? Consider allowing employees to contribute the value of their unused vacation time to their profit-sharing retirement plan. The IRS has recently sanctioned this approach by one employer and indicated the contributions are `free

from income as well as FICA employment taxes.

## **PERSONAL FINANCIAL PLANNING**

- Did you know 55% of heads of family businesses started them from scratch? Another 30% inherited the business from the previous generation, and 15% were hired to run an existing business and eventually bought out the former owners. Unfortunately, when surveyed about the future of the firm, almost three-fourths of the business heads lacked any specific plans. Responses to the question: "What will you do with your company when you retire?" were as follows:
  - < Am in the process of planning an exit strategy 49%
  - < Not in a position to determine the future of the firm 24%
  - < Plan to pass it on to my children 21%
  - < Intend to pass it on to a non-relative 7%
  
- Obtaining a divorce does not necessarily mean that two people who find that they are incompatible have to undergo extended emotional and financial pain. Intelligent couples are increasingly taking a mature approach to their problem and to devising a fair resolution. The approach is typically to:
  - < Consult a marriage counselor to determine whether the marriage is salvageable and to minimize anger or emotional damage for either partner.
  - < Obtain information about the state's divorce law.
  - < Obtain separate attorneys conversant with divorce law to insure each party's interests are protected.
  - < Reach an agreement between the spouses to accept a single appraisal of marital assets because this can avoid substantial appraisal fees.
  - < Assess the tax consequences of property settlements.
  - < Have both spouses prepare a net worth affidavit that includes budgetary living expenses, and a listing of assets and liabilities. (Different states have varying requirements.)
  - < Review the tax consequences of alimony for the parties.
  - < Reach an amicable dissolution of the marriage.

Of course, when there are children involved, the problems become more complicated. Consideration needs to be given to who has custody of the children, the amount of support payments provided by the non-custodial parent, the tax and financial consequences of either parent claiming a dependency exemption, and the psychological impact of the family separation on the children. When people are able to work out their marital dissolution in an intelligent and amicable way, both the short- and long-term results are usually much better, than if the divorce is preceded

by a nasty court battle.

- The National Association of Security Dealers (NASD) has issued an investor alert with regard to class B mutual fund shares. It is concerned investors may be steered to this class of stock by their brokers when it might be more cost effective for the investors to purchase another class of stock. Frequently, brokers receive higher commissions from the sale of Class B shares than other classes of stock, and although no front-end sales charges are imposed, investors may be subject to assessment of higher expenses over the term of their investment compared to investors in Class A shares. There is usually also a contingent deferred sales charge associated with Class B shares if the investor sells the shares within a specified period. Incidentally, some funds designate class B shares as L shares, C shares, M shares, S shares, or by some other name to distinguish them from the regular shares.

## **REAL ESTATE**

- Every landlord has horror stories about contractors who perform defective work, leave jobs partially finished or impose charges which were never mentioned at the time the contract was signed. Here are some of the common techniques used to inflate costs:
  - < Submitting invoices for work which is only generally described and not specific about the actual work done.
  - < Performing unauthorized work for the resident and billing the property owner.
  - < Billing for services or work which was never performed.
  - < Performing unnecessary work.
  - < Using incorrect labor rates which were not specified in the contract.
  - < Adding charges for use of a subcontractor when a subcontractor was not utilized.
  - < Billing for the use of unessential personnel
  - < Rounding up partial hours to the next whole hour if the contract calls for payment on an hourly basis.
  - < Inflating travel time.
  - < Double billing for items back-ordered or for work not yet begun.
  - < Including late-payment fees even if these are not specified by the contract.
  - < Incorrect computation of sales taxes which include labor charges, etc. which may not be taxable.
  - < Charging for brand name parts when generic or used parts were used.

Unfortunately, these practices are common, especially where the contractor senses the property owner is lax. To minimize over billing we recommend: (1) work to be performed is spelled out in detail in the contract; (2) billing rates, labor rates, etc. are clearly spelled out; (3) the property owner or a representative observes performance of the work and approves it upon satisfactory completion; and (4) all billings are carefully scrutinized for accuracy and supporting documentation before any payments are made.

- Tax regulations provide a first-time home buyer can withdraw up to \$10,000 from an IRA without penalty to purchase a property even though the person hasn't attained age 59 ½. But does this mean a person who once bought a home is ineligible? The answer is: "No!" Under one definition used by the IRS, a first-time home buyer is a person who has not owned a principal residence during the two-year period ending on the date of acquisition - regardless of how many homes he or she owned before. Anyone considering taking a distribution from an IRA for a home purchase should be aware the distribution must be used to purchase a principal residence and must be used within 120 days. Also, income taxes will have to be paid on the distribution. By the way, first-time home buyers include the IRA owner, the spouse, children, grandchildren, and ancestors of the individual or spouse.
- Fannie Mae and Freddie Mac have increased the maximum size of home loans they will buy from lenders, effective January 1, 2004. The new limit is \$333,700, 3.4% higher than the 2003 loan limit of \$322,700. The two companies raise the loan limits each year to reflect home price inflation based on a price index published by the Federal Housing Finance Board. The change will make it easier for home buyers to offset recent increases in housing prices. Fannie Mae estimates the change will enable 95,000 home buyers to save as much as \$21,900 over the term of a 30-year mortgage.

## **TAXATION**

- The IRS and state tax officials nationwide, have established a partnership designed to combat abusive tax shelters. According to the IRS, the agencies will share information on abusive tax avoidance transactions and the taxpayers who participate in them. The IRS says the agreements are designed to enable both state and Federal governments to be more aggressive in ensuring all taxpayers pay their fair share of taxes. One business area being investigated right now are automobile dealerships. The IRS says it has identified an increase in scams and fraud involving the automotive sales industry and its criminal investigations division is in the process of conducting investigations relating to tax evasion, employment tax fraud, money laundering conspiracies and violations of the Bank Secrecy Act.
- The IRS has announced payments made to surviving family members from the 9-11 Victim Compensation Fund are tax-free whether made in the form of a lump-sum or periodic payments. Claims had to be filed by December 22, 2003, and more than 95% of victims' family members have opted for payments from the fund rather than seeking higher pay-outs via litigation.

- In general, medications are deductible as personal itemized medical costs only if they are prescribed by a doctor. But an increasing number of prescription drugs can now be purchased over-the-counter. Although the cost of these medications are not deductible as itemized expenses, they can now be bought on a pre-tax basis by employees and reimbursed to them under an employer sponsored health flexible spending arrangement (FSA). The IRS has held the definition of "medical care" for tax-free reimbursement purposes is broader than for itemized deduction purposes. Consequently, health FSAs can cover antacids, allergy medications, pain relievers, cold remedies and other such items taken to alleviate or treat personal injuries or sickness. However, over-the-counter medications for general good health such as vitamins or dietary supplements are not reimbursable. If you are participating in an employer's health FSA, you should factor this in when determining how much of your pre-tax salary to contribute to the plan.
  
- The Jobs and Growth Tax Relief and Reconciliation Act of 2003 provided for increases in the first-year bonus depreciation allowance and also expanded the Section 179 expensing deduction for business. Tax legislation in 2002, created a special first-year bonus depreciation allowance of 30% of the adjusted basis of "qualified" property (equipment, machinery, furniture, cars, trucks and off-the-shelf computer equipment) placed in service during a specified time frame. The 2003 Act increased the first-year bonus depreciation allowance from 30% to 50% for qualified property acquired after May 5, 2003 and placed in service before January 1, 2005 (January 1, 2006 for long-term production property). Taxpayers may elect to use the 50% allowance, the 30% allowance, or to not claim any special allowance. There are also special "luxury auto" rules for vehicles limit the annual depreciation deduction a taxpayer can claim for a business auto. For cars first placed in service in 2002 and used more than 50% in business, the first year limit was \$3,060, plus an additional 30% first-year bonus depreciation amount of \$4,600, for a total amount of first-year depreciation in 2002 of \$7,660. The 2003 Act provides the additional first-year bonus depreciation for qualifying autos placed in service in 2003 is \$7,650 rather than \$4,600, raising the 2003 first-year allowable depreciation limit to \$10,710 (\$3,060 + \$7,650) subject to adjustment for inflation. Finally, under Section 179 of the Internal Revenue Code, taxpayers other than estates and trusts could deduct as an expense, rather than depreciate, up to a specified amount of the cost of certain personal property placed in service during the year. Prior to the 2003 Act the maximum that could be expensed annually was \$25,000 for tax years beginning in 2003, and the limit was reduced by the amount by which the cost of qualifying property placed in service during the tax year exceeded \$200,000. The 2003 Act raised the maximum qualifying Section 179 amount to \$100,000 (indexed for inflation after 2003) for property placed in service in 2003, 2004 and 2005, and also increased the phase out amount from \$200,000 to \$400,000. These changes can have a significant cash flow impact on many businesses and require review of business equipment acquisition planning decisions.
  
- The General Accounting Office says tax revenues were \$654 million less in 2000 because of taxpayer vehicle donation deductions, but charities collected only a small amount of the deductions taken when disposing of the cars. Therefore, the IRS has its eye on taxpayers who donate their cars to charity because the Agency believes the charitable contribution deductions taken are inflated. It's considering requiring the donors to show proof their vehicles were worth the amount shown on the tax return.

One possibility is to have the charity report to the donor and the IRS what the car fetched when it was sold by the organization, and use that amount as the amount which can be deducted by the donor. In the meantime, taxpayers are cautioned the deduction is limited to the fair market value of the vehicle. The Agency is also reminding taxpayers all contributions of cash or property over \$250 require a written acknowledgment by the charity, and contributions of property over \$5,000 in the aggregate, such as stamps or coins, whether made to one or more charities require a written appraisal from an expert.

- Partners and S corporation shareholders which failed to do enough seasonal business to use a fiscal year for tax purposes and have to switch to a calendar year are being given a tax break. The IRS is allowing them to report the income from the partnership or S-corporation's short tax year over a 4-year period. Formerly the full tax had to be paid in the year of the switch. The IRS largesse only applies to short tax years ending on or after May 10, 2002.
- The IRS says owner-executives of S corporations may intentionally pay themselves an inadequate salary to minimize payroll taxes. Unlike C corporations which often pay excessive salaries to avoid paying dividends, S corporations have all of their income taxed on the owners' tax returns so there is no excessive salary issue. The Agency is alerting its auditors to pay more attention to the inadequate salary issue when examining S corporations. Salaries should be justifiable based on the size of the organization and the responsibilities of its owner-executives.

## **PAYROLL TAXES**

- Want to reduce your payroll taxes without cutting your payroll? Here are some ideas to consider:
  - < Offer flexible spending arrangements to cover employees' health care costs or dependent care expenses.
  - < Reimburse employees for travel and entertainment expenses using an "accountable" plan rather than using standard per mile and per diem rates.
  - < Provide employees with additional fringe benefits which are exempt from FICA and FUTA taxes rather than giving them raises.
  - < Time bonuses so they come at a time when most employees' incomes already exceed the Social Security wage base.
  - < Let employees keep jury duty pay rather than turning it in, and reduce their wages by that amount. Then payroll taxes will only be due on the reduced wages.

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](mailto:info@facpa.com).