

COMMENTS - JUNE, 2001

ADMINISTRATION, SYSTEMS AND EDP

E-commerce is revolutionizing the way small businesses with fewer than 100 workers are conducting their business. Even so, according to one survey, the 7.4 million small businesses in the United States have a mixed record when it comes to adopting new technology. For example:

1. 84% use personal computers
2. 73% utilize cellular phones
3. 57% have Internet access.

Conversely, only 28% use pagers; just 24% have an Internet web site and only 8% engage in E-commerce. Is your firm regularly reviewing new technology to determine whether it can enhance your business, improve customer relationships, lower operating costs or provide some other advantage?

If you are replacing old computers for your business or home, don't just dump them, but rather give them to a charity. In 2001 and through December 31, 2003, C corporations can deduct up to 200% of the cost of computers and peripherals donated to schools (grades K through 12) and to libraries. S corporations and other business entities are not entitled to such liberal contribution deductions. Their deductions are limited to their adjusted cost which could be zero if the equipment was originally expensed or if it is fully depreciated. To find a local charity who has a computer recycling program you can go on the Internet to www.microweb.com/pepsite. There, you'll be able to access the "PEP National Directory of Computer Recycling Programs." Not only will your gift help someone, but you'll also be able to obtain a tax benefit.

FEDERAL REGULATIONS

Mutual fund investors are taxed on fund distributions when a fund distributes its dividends and capital gains. As a result, funds with the same pre-tax return may have a very different after-tax yield for their investors. It's even possible funds which have declined in value for the year can make significant capital gains distributions on which the investor is taxed. Furthermore, depending on the size of the distributions and the investor's tax bracket, the tax effect of a fund's distribution will vary for different investors. Now, in order to provide better information for investors, the SEC is requiring mutual funds not only to provide the pre-tax performance, but also, to disclose the after-tax return on their funds.

The IRS has offered additional guidance on health coverage continuation (COBRA) rules. The rules require firms with 20 or more employees to offer departing workers the option to buy continued medical insurance for at least 18 months at premiums that can't exceed 2% of the employer's cost. The new regulations deal with situations where the departed worker fails to fully pay the premiums. According to the IRS, coverage can't be immediately discontinued for small

premium shortfalls. Instead, if the underpayment does not exceed the lesser of \$50 or 10% of the premium, the employer must either pay the difference or provide a grace period of at least 30 days for the ex-employee to make the payment before coverage may be terminated.

INSURANCE

If you receive insurance reimbursements that compensate your business for lost income, the proceeds are fully taxable. On the other hand, when business owners are compensated for property damage, and the insurance proceeds are used to buy replacement property, this is usually not a taxable event. Thus, property damage indemnification is more valuable from a tax standpoint than lost income indemnification. Furthermore, to avoid IRS inference that insurance proceeds are compensation for lost income:

1. Have policies provide loss-of-value coverage that indemnifies you for loss of value of assets.
2. Arrange for benefits to be paid on a flat per diem basis, without any mention of income or profits.
3. Make sure policies make no reference to past profits and establish no limits based on past profits.

Despite the overall bleak business conditions, insurance costs are on the rise again, and as a business owner you may get sticker shock. Here are minimum premium increases you can expect when you are ready to renew various commercial insurance contracts:

Commercial auto insurance	9.0%
Commercial multi-peril insurance	8.3%
Commercial property insurance	8.8%
General liability insurance	7.8%
Umbrella insurance	6.1%
Workers' comp insurance	9.5%
Health insurance	13.0%

Although the figures far outpace overall inflation, insurance companies have not raised prices for a number of years because they've been in a severe struggle to gain market share and they have realized tremendous stock market gains. Thus, the increases partially reflect premium adjustments which are needed to obtain profitable operations.

LABOR RELATIONS

Medical Flexible Spending Accounts (MSAs) can be one of the most valuable benefits provided by a small employer. They give plan participants the equivalent of a tax deduction, for medical expenses which would not otherwise be deductible, through the use of pre-tax dollars for paying for the medical expenditure. Here is how MSAs work:

1. Small employers, those with 50 or fewer employees during either of the past two years are eligible to establish an MSA.

2. Typically, the employer takes out a low-premium, high deductible group health insurance policy for the employees and then supplements it with an MSA.
3. Participating employees make pre-tax contributions up to established limits to their MSA account each year, with the earnings accumulating tax deferred.
4. When uninsured medical expenses which are tax deductible under regular tax rules are incurred, the worker pays for the expenses with the funds from his or her MSA.
5. Money that is deposited each year into an MSA and not used is lost, so employees must try to match the amount deposited with their anticipated uninsured medical expenditures and use up any excess to purchase medical supplies or make doctor's visits before year-end. (Participants over age 65 may make penalty-free withdrawals from their MSAs for non-medical purposes.)

One area of constant dispute between the IRS and small business owners, is the reasonableness of compensation paid to key executives. The IRS frequently challenges compensation as disguised dividends designed to lower the tax liability of the company and its owners. In determining the reasonableness of compensation, the IRS applies the following five tests:

1. The role and responsibilities of the executive.
2. Compensation of executives with comparable responsibility at comparable companies.
3. The financial condition and character of the company.
4. Conflicts of interest between the executives and how their compensation is determined. (Involvement of an independent third party, etc.)
5. Existence of a formula for determining the compensation.

When these tests don't provide a clear-cut indication, the IRS will also look at such other factors as existence of loans between the company and the executive; dividend history of the company and salary history of the individual. From the company's standpoint, in evaluating reasonableness of compensation and fending off an IRS challenge, it is extremely important that all compensation programs and policies are thoroughly documented, that the compensation policies and programs are determined as though an independent institutional investor needs to be satisfied, and that objective, formula based calculations are consistently utilized in determining and administering compensation levels.

MARKETING

Having a catchy domain name for your web site may be extremely important for drawing customers to the site. Therefore, experts recommend domain names or "urls" should be: (1) simple and easy to spell; (2) informative to users about what a company does, and (3) resonate in people's minds. Companies are also advised to note misspellings of their domain name which frequently recur and register those as separate domain names as a means of capturing additional traffic for their business and preventing competitors from using them. If you already have a web site and are unhappy with the domain name you have chosen, you're about to have a chance to select from seven new domain categories which were recently approved by the Internet Corporation for Assigned Names and Numbers. In

addition to the old ".com," ".org," and ".net" you'll now be able to register urls with the following suffixes: ".biz," ".info," ".name," ".pro," ".museum," ".aero," and ".coop." There are restrictions on the use of the new suffixes, so you need to first determine whether you qualify.

MONEY, BANKING AND CREDIT

Now that we have the first serious business slowdown in almost a decade, business managers are increasingly focused on cutting costs. One operational area where this is possible is the purchasing function and here are some cost-cutting ideas which may be useful:

1. Make returns of excess shipments from suppliers at the supplier's expense.
2. Try to obtain extra discounts or longer payment terms from vendors.
3. Establish an approval level for all purchases above a specified dollar amount.
4. Consolidate suppliers, if possible, to reduce your firm's paperwork.
5. Require multiple bids for large purchases.
6. Review invoices for errors before payment and compare prices and quantities with purchase orders.
7. Evaluate vendor performance at least annually.
8. Review minimum inventory quantities to minimize excessive investment in inventories.

These are just a few thoughts for enhancing purchase efficiency and lowering overall business operating costs.

PENSION AND ESTATE PLANNING

If you are a participant in a defined benefit pension plan over a prescribed period, upon retirement you will be entitled to receive a steady income for the remainder of your life in an amount that depends on the number of years you have worked for the employer. Usually, there are three payout options. They are:

1. Maximum payout option which provides the highest pension but pays only during the life of the pensioner.
2. 100% joint and survivor option which pays a reduced pension but makes the payments over the lives of the pensioner and a designated beneficiary.
3. 50% joint and survivor option which provides for a pension between the other two options. Here, a somewhat reduced pension is paid during the pensioner's life, and subsequently, 50% of the original amount is paid over the life of the beneficiary.

Factors to consider in making a suitable payout election include the pensioner's health; health and pension benefits of a spouse; need to provide protection for children; financial needs of the pensioner after retirement; use and cost of life insurance to replace pension income; and, taxation of pension benefits.

PERSONAL FINANCIAL PLANNING

Non-compete agreements are commonly used to protect a company against the possibility a key executive may leave the firm and solicit a large portion of the

existing customer base. It is also used in business sales to protect the purchaser by insuring the seller does not start a competing business in the same geographic area for a period of time. Unfortunately, courts have frequently invalidated non-compete agreements because no consideration was provided in exchange for signing the agreement. This situation does not usually arise in a business sale because a portion of the price is attributed to the noncompete agreement. However, it often occurs when an employee who is already working for the company is asked to sign such an agreement as added protection for the employer. It's important to obtain the advice of the company's attorney to assure a legitimate contractual arrangement has been concluded, which will not be challenged by a court.

- # Many investors buy CDs from brokerage firms. Higher yields are offered than at local banks because the broker can negotiate better yields based on the large deposits it can generate for the bank. But these accounts may involve more risk than the purchaser anticipates. For example, some brokers, to obtain this business, may promise there are no early withdrawal penalties if the investor wants to get out before the maturity date. But this can only be achieved if the broker sells the CD to another customer rather than having the bank cash it in. If interest rates have risen since the investor purchased the CD and maturity is still a ways off, it means the broker would have to sell the CD at a significant discount and the investor would suffer a loss of principal. Other surprises investors have experienced with brokered CDs may include early redemption provisions, high early withdrawal penalties, fluctuating interest rates which are based on a stock index and lack of FDIC insurance. We suggest readers who purchase brokered CDs only deal with a reputable brokerage firm and fully understand the CD they are purchasing.

REAL ESTATE

- # As interest rates fall again, some homeowners are thinking of refinancing an existing mortgage. If you are among them, you should be aware lower interest rates don't always signal it is time to refinance. As a rule of thumb, refinancing makes sense if you recover your refinancing costs within 18 months and plan to stay in the home for five to seven years. It's also necessary to consider the tax aspects of a refinancing. These relate to:

1. Deductibility of interest on the new mortgage.
2. Deductibility of points paid on the new mortgage.
3. Deduction of any prepayment penalty to pay off the existing mortgage.
4. Deduction of the balance of points on the old mortgage.

We can analyze these factors and recommend your best course of action. Even if refinancing does not make economic sense, you might consider utilizing any excess cash flow to make one or two extra mortgage payments each year. This will accelerate amortization of your mortgage and result in considerable interest savings over the long term. You might want a free copy of "A Consumer's Guide to Home Refinancings." It's available from the Federal Reserve Bank of New York, Public Information Department, 33 Liberty St., New York, N.Y. 10045. The bank can also be reached over the Internet at: www.ny.frb.org/pihome.

TAXATION

- # Taxpayers have three years from the due date of a return to claim a refund of taxes. However, whether a timely claim is made depends on whether the refund filing date is the postmark date on the envelope or the date when the IRS actually receives the claim. Unfortunately, tax regulations are unclear on this issue, and various U.S. Appeal Courts have held contrary positions. However, the IRS recently released regulations that establish the mailing date on the envelope as controlling in determining whether credit and refund claims were filed on a timely basis. This should, once and for all eliminate confusion in this area.
- # Estimated tax rules for 2001 have been changed once again. To avoid underpayment penalties, taxpayers with adjusted gross income over \$150,000 in 2000, must prepay at least 110% of their amount of their year 2000 tax for 2001, or 90% of year 2001 tax liability. Those with incomes under \$150,000 in 2000 must either prepay at least an amount equal to 100% of their year 2000 tax for 2001 or 90% of year 2001 tax liability.
- # Taxpayers who incur legal fees should always obtain an itemized bill from their attorney. The reason for this admonition is to the extent legal fees are incurred to secure taxable income or to reduce taxes, they are tax deductible. Examples of the former include negotiation of an employment contract or expenditures for collecting alimony, while expenses of drafting a will or assisting with tax planning fall into the latter category. Of course, the same suggestion applies with respect to services from CPAs.

PAYROLL TAXES

- # A U.S. Court of Appeals has ruled that an early retirement incentive in which an employer attempted to reduce its workforce by offering employees a lump-sum payment based on length of service and their pay level is subject to payroll taxes. The reason the payroll taxes are due on the early retirement pay-out is the benefit was based on past employment with the firm. Had a different formula been used, it might have been possible to save payroll taxes for both employer and retirees.

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