

May 2001

# THE PENNSYLVANIA ACCOUNTANT



*The Newsletter Of The Pennsylvania Society Of Public Accountants*

**• 54TH ANNUAL MEETING  
HARRISBURG HILTON & TOWERS  
JUNE 21-24, 2001**

- State & Local Tax Update**
- Upcoming Seminar Dates  
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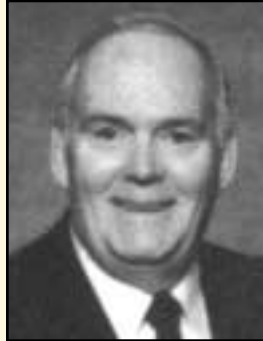
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## A Message From The President



By the time this issue of the Pennsylvania Accountant is delivered to your office, the 2000 tax-filing season will be over. I hope each of you had a successful and prosperous tax season and I encourage everyone to relax and recharge your mental batteries.

During our busiest time of the year we give little thought to the world outside of our four office walls; many parts of our lives are put "on hold" for three and a half long months until we are able to rise to the surface and once again take a deep breath. One thing that is not put on hold during tax season are the functions and daily responsibilities of PSPA. I would be remiss if I did not recognize the tireless efforts of our Executive Director Sherry L. DeAgostino and her staff, who very capably and commendably administer this organization both inside and outside of tax season.

Many of you corresponded with us via telephone or email offering your appreciation to the PSPA for timely information you received either in the form of email or when contacting the Executive Office during tax season. Thank you for your kind words of praise, and be assured that PSPA will continue to put its members first.

The PSPA Technology Committee has gathered proposals from several reputable companies to redevelop the PSPA website. The Committee will be reviewing the proposals and will meet in conjunction with the May Board of Directors meeting to move forward on the project.

If you haven't already, make plans to attend the 54<sup>th</sup> Annual Meeting of the PSPA. All PSPA members have received convention registration material under separate cover. I am extremely pleased with the work of the convention committee in planning the upcoming Harrisburg convention. This year's event is extremely affordable, and is packed full of fun activities for both adults and children. If you've never attended an annual meeting, why not make this your first?

Respectfully Submitted,

William C. Graham, PA  
President





## **JOIN A COMMITTEE!!**

PSPA President Elect, Bernard A. Deverson, CPA is currently setting up his standing committees for the 2001-2002 year. Members who are interested in serving on one of the PSPA standing committees should contact the PSPA Executive Office at 1-800-270-3352 before June 1, 2001.

### **PSPA Standing Committees**

- Banking Relations
- Bylaws
- Committee on Cooperation with IRS
- Committee on Cooperation with the PA Department of Revenue
- Committee on Monitoring the State Board of Accountancy
- Committee on Professional Conduct & Grievances
- Education
- Legislative
- Membership/Public Relations
- PSPA/PICPA Liaison

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# **54<sup>TH</sup> ANNUAL MEETING**



Register now to attend the  
PSPA 54th Annual Meeting!

*June 21-24, 2001  
Hilton Hotel & Towers  
Downtown Harrisburg, PA*

Registration material has been  
sent to all PSPA members under separate cover.



# *NSA State Director's Message*

*PSPA Officers, Board of Directors and Members:*

The 2000 tax season is history, well, that is except for extensions. I hope you didn't have many of these so you can enjoy the nice hot weather.

I want to encourage everyone to make plans to attend PSPA's convention, June 21-24, 2001, in Harrisburg, and NSA's 56th annual convention, August 22-29, 2001, in Minneapolis, MN. The annual conventions are a time for earning CPE credits, networking with your colleagues and lots of fun. In addition, you get to travel and see different parts of the country that you otherwise might never see.



NSA has been busy as usual with many projects:

1. NSA was the only accounting association represented at the breakfast discussion with the Democratic Members of the House Small Business Committee March 29, 2001. Representative Nydia M. Velazquez hosted the meeting that allowed us to voice our concerns on the AMT and Offer-in-Compromise programs. Subsequent monthly meetings will allow NSA to continue to provide input on small business issues.

2. NSA was present at the IRS Oversight Committee's first public meeting on March 20, 2001. Steve Rafsky, the new chair of the IRPAC, spoke confirming IRPAC's support of the IRS strategic plan and asked that more funds be budgeted so the IRS can increase its staffing and its surveillance. Immediately following the meeting NSA sent an e-mail alert to members informing them of what had taken place.

3. A press release went out to the Accounting Industry and Aging Services press on March 28, 2001, announcing the Serving Aging American Conference. The press release is on NSA's Web Site, NSACCT.ORG, under Industry News.

4. NSA is soliciting software companies to be listed in the Software Buyer's Guide that will appear as an insert in the June NPA Technology issue.

Respectfully submitted,

Margaret A. Romain-Johnson  
PA State Director, District II

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**SCHEDULES C, F, SE**

**SCHEDULE D FORM 497**

**SCHEDULE E PASSENGER FORM 709**

**FORM 4982**

**TAX CREDITS & MISC.**

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**TAX LAW & NEWS INDEX**

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Mark E. Motluck, Palos Heights, Illinois

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Thanks. Beth H. Waguespack, Baton Rouge, Louisiana

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## **McNees, Wallace & Nurick STATE & LOCAL TAX UPDATE**

By Sharon R. Paxton, Esq.

### **2001-2002 BUDGET PROPOSAL - GOVERNOR CALLS FOR SCHOLARSHIP TAX CREDIT & OTHER MODEST TAX BREAKS**

In his budget address for the 2001-2002 fiscal year, Governor Ridge proposed the following tax cuts:

- Twice-yearly personal computer Sales Tax holiday to be continued (\$10.7million)
- Job Creation Tax Credit allocation to be increased (\$2.5 million)
- Neighborhood Assistance Tax Credit program to be expanded, including credit to corporations which fund scholarships for low income families (\$12.0 million)
- Poverty exemption under Personal Income Tax to be increased, so family of four with \$30,000 income will pay no PIT (\$17.8 million)
- Marriage License Tax, Writ Tax and Private Bankers Gross Receipts Tax to be repealed (\$1.6 million)

In addition, the 1.5 mill reduction in the Capital Stock/Franchise Tax rate for 2001 and the 1 mill reduction for 2002, which are part of the phase-out enacted last year, will cost the Commonwealth \$172.3 million in lost revenue for fiscal year 2001-2002.

### **INSOLVENT CORPORATION'S DISCHARGE OF INDEBTEDNESS INCOME NOT INCLUDIBLE IN BOOK INCOME UNDER CAPITAL STOCK TAX**

In *Shawnee Development, Inc. v. Commonwealth*, the Commonwealth Court ruled that an insolvent corporation's income from discharge of indebtedness is not to be included in its "income per books" for Capital Stock Tax purposes because such income is excluded from the definition of "gross income" under the Internal Revenue Code. Since neither the Tax Reform Code nor the applicable regulations define the term "income per books" for Capital Stock Tax purposes, the Court concluded that the "peculiar and appropriate meaning" which the term has acquired is grounded in federal income tax law. The Department of

Revenue had characterized the taxpayer's debt forgiveness as a nonrecurring or extraordinary income item, which was required to be included in book income for Capital Stock Tax purposes. The Court has granted the Commonwealth's application for reargument of this case, and the Commonwealth is expected to argue that the Court improperly applied federal income tax rules instead of generally accepted accounting rules.

### **PURCHASERS OF BUSINESSES MUST BEWARE OF TRANSFEROR'S TAXES**

In *Commonwealth v. Qwest Transmission, Inc.*, the Commonwealth Court held that a corporation's failure to obtain a bulk sale clearance certificate at the time of conveyance precluded it from later challenging the amount of taxes owed by the transferor (as a result of a prior merger with another corporation), where the tax settlement was not timely appealed. This result was not altered by the fact that the Department of Revenue had issued the settlement notice to the corporation originally liable for the taxes and not to the bulk sale purchaser from whom it was attempting to collect the outstanding taxes. The Court reasoned that the purchasing corporation would have had an adequate opportunity to have a judicial determination of the amount of taxes due if it had secured a bulk sale clearance certificate in accordance with Section 1403 of the Fiscal Code. A petition for allowance of appeal has been filed with the Pennsylvania Supreme Court.

### **NO REALTY TRANSFER TAX IN CONVERSION TO LIMITED PARTNERSHIP**

In *Exton Plaza Associates v. Commonwealth*, the Commonwealth Court held that a deed executed as a result of a conversion from a general partnership to a limited partnership does not trigger Realty Transfer Tax, as long as the ownership interests do not change. According to the Court, such a conversion does not represent a meaningful transfer of title to someone other than the grantor.

### **AVAILABILITY OF CHARITABLE EXEMPTION UNDER ACT 55 LIMITED**

In *Community Options, Inc. v. Board of Property Assessment, Appeals and Review*, the Commonwealth Court recently ruled that an entity which does not qualify for the charitable tax exemption under the HUP test cannot qualify for exemption under Act 55. That is, if an entity does not qualify under the constitutional standard embodied in the



HUP test, it cannot qualify for exemption by satisfying the standard set forth in Act 55. A petition for allowance of appeal has been filed with the Pennsylvania Supreme Court.

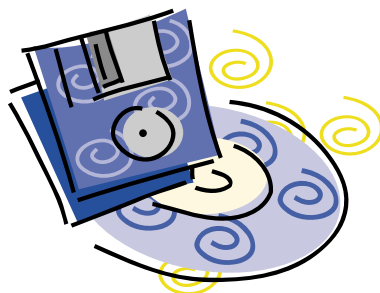
## DOCUMENT REPRODUCTION SERVICES NOT MANUFACTURING UNDER LTEA

In Ikon Office Solutions, the Commonwealth Court ruled that document reproduction services do not qualify for the "manufacturing" exemption for Business Privilege Tax purposes. The Court of Common Pleas of Allegheny County had determined that photocopying activities qualify for the exemption because blank paper and toner are transformed into a new, different and useful item. The Commonwealth Court disagreed, holding that photocopying is not manufacturing because it creates "no more than a superficial change in the original materials" and "is not manufacturing in the popular and practical understanding."

## REGULATION-PRONOUNCEMENT STATUS REPORT

According to the Department of Revenue's quarterly "Regulation-Pronouncement Status Report" for the first quarter of 2001, topics to be addressed by regulation or pronouncement include: Sales Tax on Computer Software, Hardware and Related Transactions, Vending Machines and Construction Contracts; Partial Refunds of Sales Tax for Bad Debts; Personal Income Tax on Supplemental Unemployment Benefit Plans and Termination Pay, Severance Pay and Early Retirement Incentive Programs; Realty Transfer Tax Amendments; and the Utility Gross Receipts Tax.

*Sharon R. Paxton is a member of McNeese, Wallace & Nurick's State and Local Tax Practice Group. Additional information may be obtained at the firm's "Pennsylvania Tax Page" on the Internet at: [www.mwn.com/public/patax.html](http://www.mwn.com/public/patax.html).*

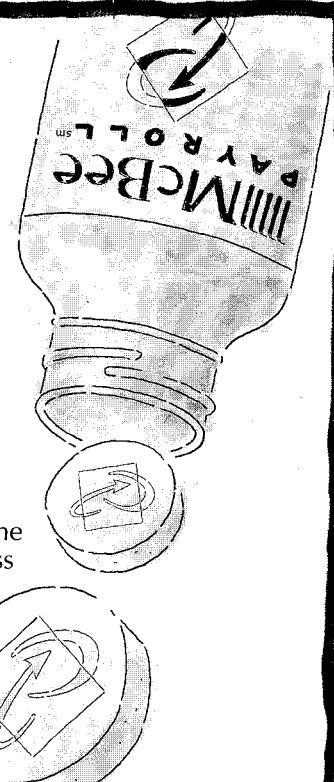


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# Chapter Dates

## Buxmont Chapter

"Meets the Fourth Tuesday of the Month"  
(unless otherwise noted)

June 26, 2001

**WHERE:** Williamson's Restaurant, Willow Grove  
**TOPIC:** To Be Announced  
**DINNER:** 6:00 PM  
**PROGRAM:** 7:00 PM

September 25, 2001

**WHERE:** Williamson's Restaurant, Willow Grove  
**TOPIC:** To Be Announced  
**DINNER:** 6:00 PM  
**PROGRAM:** 7:00 PM

October 23, 2001

**WHERE:** Williamson's Restaurant, Willow Grove  
**TOPIC:** To Be Announced  
**DINNER:** 6:00 PM  
**PROGRAM:** 7:00 PM

November 20, 2001 (Third Tuesday)

**WHERE:** Williamson's Restaurant, Willow Grove  
**TOPIC:** To Be Announced  
**DINNER:** 6:00 PM  
**PROGRAM:** 7:00 PM

December 18, 2001 (Third Tuesday)

**WHERE:** Williamson's Restaurant, Willow Grove  
**TOPIC:** To Be Announced  
**DINNER:** 6:00 PM  
**PROGRAM:** 7:00 PM

## Lehigh Valley Chapter

"Meets the Third Tuesday of the Month"  
(unless otherwise noted)

May 15, 2001

**TOPIC:** To Be Announced  
**WHERE:** Holiday Inn Bethlehem

June 19, 2001

**TOPIC:** To Be Announced  
**WHERE:** Holiday Inn Bethlehem

July 17, 2001

**TOPIC:** To Be Announced  
**WHERE:** Holiday Inn Bethlehem

## South Central Chapter

"Meets the Third Wednesday of the Month"  
(unless otherwise noted)

May 23, 2001

**WHERE:** Officer's Club, Mechanicsburg  
**TOPIC:** Offers in Compromise  
**SPEAKER:** Jay S. Block, Attorney at Law, CPA  
• CPE: 4 Hours Tax

June 22, 2001

(In Conjunction with PSPA 54th CONVENTION)  
**WHERE:** Allenberry Playhouse  
**PLAY:** Wizard of OZ

July 18, 2001

**WHERE:** Officer's Club, Mechanicsburg  
**TOPIC:** To Be Announced







# Seminar Dates

## Gear Up Estates & Trust Seminar

June 27 & 28, 2001  
Radison Hotel, Trevoise  
CPE: 16 Hours Tax  
Sponsored By: Buxmont Chapter

September 25, 2001  
Radison Hotel, Monroeville  
CPE: 8 Hours Tax  
Sponsored By: Pittsburgh Chapter

October 17, 2001  
Holiday Inn, Dunmore  
CPE: 8 Hours Tax  
Sponsored By: NorthEast Chapter

## Gear Up Accounting Seminar

June 11 & 12, 2001  
Willow Valley Resort & Conference Center  
CPE: 16 Hours Accounting  
Sponsored By: Central/South Central Chapter  
Joint Education Committee

June 18, 2001  
Radison Hotel, Monroeville  
CPE: 8 Hours A&A  
Sponsored By: Pittsburgh Chapter

June 20, 2001  
Holiday Inn, Dunmore  
CPE: 8 Hours Accounting  
Sponsored By: NorthEast Chapter

September 19 & 20, 2001  
Holiday Inn Bethlehem  
CPE: 16 Hours Accounting  
Sponsored By: Lehigh Valley Chapter

September 21, 2001  
Radison Hotel, Trevoise  
CPE: 8 Hours Accounting  
Sponsored By: Buxmont Chapter

## Gear Up Business Entities Seminar

September 12, 2001  
Holiday Inn, Dunmore  
CPE: 8 Hours Tax  
Sponsored By: NorthEast Chapter

October 1 & 2, 2001  
Radison Penn Harris Hotel & Convention Center  
CPE: 16 Hours Tax  
Sponsored By: Central/South Central Chapter  
Joint Education Committee

October 18, 2001  
Radisson Hotel, Monroeville  
CPE: 8 Hours Tax  
Sponsored By: Pittsburgh Chapter

October 25 & 26, 2001  
Radisson Hotel, Trevoise  
CPE: 16 Hours Tax  
Sponsored By: Buxmont Chapter

## Gear Up 1040 Tax Seminar

November 7 & 8, 2001  
Woodlands Inn & Resort, Wilkes-Barre  
CPE: 16 Hours Tax  
Sponsored By: NorthEast Chapter

November 26 & 27, 2001  
Radison Hotel, Trevoise  
CPE: 16 Hours Tax  
Sponsored By: Buxmont Chapter

December 3 & 4, 2001  
Holiday Inn Bethlehem  
CPE: 16 Hours Tax  
Sponsored By: Lehigh Valley Chapter

December 13 & 14, 2001  
Radison Hotel, Monroeville  
CPE: 16 Hours Tax  
Sponsored By: Pittsburgh Chapter

December 3 & 4, 2001 / December 17 & 18, 2001  
*Seating is limited. Please register early to get your choice of dates.*

Harrisburg Marriott  
CPE: 16 Hours Tax  
Sponsored By: Central/South Central Chapter  
Joint Education Committee

## GAAP Update

May 22, 2001  
Holiday Inn, Dunmore  
CPE: 4 Hours Accounting & Auditing  
Sponsored By: NorthEast Chapter

## Estate Planning

May 31, 2001  
Clarion Inn, Lewistown  
CPE: 4 Hours Accounting, 4 Hours Tax  
Speaker: Julie Steinbaker, Gerontologist  
Topic: Long Term Health Care &  
Effects on Estate Planning  
Sponsored By: West Central Chapter

Registration Material  
has been sent  
under separate cover.

# 54<sup>TH</sup> ANNUAL MEETING

June 21-24, 2001

Hilton Hotel & Towers

Downtown Harrisburg, PA

## HIGHLIGHTS OF THE 54th ANNUAL MEETING INCLUDE:

- Complete private tour of Pennsylvania's beautiful capitol building, & reception in the capitol rotunda
- Allenberry Dinner Theater's showing of the WIZARD OF OZ
- Historic tour of Harrisburg, including a guided tour of Harrisburg and lunch & tour at the National Civil War Museum...
- Luncheon Cruise on the "Pride of the Susquehanna" with time to enjoy Harrisburg's City Island

*Price of \$595 per couple double occupancy includes three night overnight room, breakfast & dinner (3 days) plus breakfast on Sunday, Lunch on the Pride of the Susquehanna, all activities tours etc., all taxes and gratuities.*



Capitol Fountain at East Wing



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Mansion

*State  
Museum*



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John Harris Mansion



The Capitol Complex



National Civil War Museum



Capitol Rotunda





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Show your support of the Pennsylvania Society of Public Accountants' 54<sup>th</sup> Annual Meeting by advertising in our convention program. If you are interested, please complete the form below, attach payment and your camera-ready advertisement (a business card is suitable) and mail to the address listed.

## 54<sup>th</sup> ANNUAL PSPA CONVENTION PROGRAM

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The deadline to submit an advertisement is May 25, 2001.

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# Odds & Ends

## SAS No. 93 Issued

The Auditing Standards Board has issued SAS No. 93, "Omnibus Statement on Auditing Standards - 2000." It contains three sections with different effective dates as follows:

The withdrawal of SAS No. 75 is effective for agreed upon procedures engagements for which the subject matter or assertion is as of, or for a period ending on or after June 1, 2001.

An amendment of SAS No. 58 is effective for reports issued or reissued on or after June 30, 2001, although earlier application is permitted.

An amendment of SAS No. 84 is effective for audits of financial statements for periods ending on or after June 30, 2001, and earlier application is also permitted.

## SSARS No. 8 Issued

The Accounting and Review Service Committee of the AICPA has issued Statement on Standards for Accounting and Review Services No. 8. Amendment to Statement on Standards for Accounting and Review Services No. 1. It does not change the performance or reporting standards of SSARS No. 1, but provides a new communications option for accountants when performing compilation engagements in which the financial statements are not expected to be used by a third party. Accordingly, the accountant can issue a compilation report in accordance with the reporting requirements of SSARS No. 1, or, alternatively, document an understanding with the entity through the use of an engagement letter, preferably signed by management, regarding the service to be performed and the limitations on the use of the financial statements. The accountant's professional judgment will determine the communications option that is appropriate. If the new, alternative option is used by the accountant, its effect is the issuance of "plain paper statements." SSARS No. 8 is effective for financial statements submitted after Dec. 31, 2000.

## "Ethics Audits"

The increase in Federal, state and local laws and regulations governing sex discrimination, race discrimination and civil rights violations, together with increased litigation in these areas, is inducing an increasing number of firms to seek so-called "ethics" audits to minimize potentially costly exposure to risk. Essentially, an ethics audit is an opera-

tional audit designed to determine whether adequate controls are in place to prevent and detect unethical behavior by your company supervisory personnel and to insure that your firm is in compliance with regulatory requirements. If deficiencies are found, they are highlighted for management together with recommendations for corrective action. Education of supervisors, use of company manuals detailing appropriate actions, and revision of company policies are just a few of the types of recommendations that may prevent damaging litigation.

## E-Commerce

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 a new technology. For example:

- 84% use personal computers
- 73% utilize cellular phones
- 57% have Internet access.

Conversely, only 28% use pagers; just 24% have an Internet web site, and only 8% engage in e-commerce.



## The Internet has Come to the Farm

The Internet has come to the farm. Several Internet startups are now providing online exchanges that are virtual seed, feed and chemical stores. Farmers with Internet access can visit these sites to compare prices and purchase these and other products on line. Agricultural business in the U.S. is a \$185 billion industry and the web sites may display well over 1,000 products in categories such as seed, animal health, crop production, machinery/parts, technology and financial services for farmers. Some of the sites also provide content on such topics as Washington and local agricultural news, and science, health and technology information.

## FTC Warns Online Retailers

The Federal Trade Commission is warning online retailers that they face potentially big fines for violating the "Mail or Telephone Order Merchandise Rule." The rule requires

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# Odds & Ends

merchants who sell products via the mail, telephone and the Internet (since it uses telephone lines) to notify customers by specified deadlines if delivery of an order is being delayed, and to offer the option of canceling the order or agreeing to a new shipment date. When it comes to Internet orders, the clock starts running the moment the online shopper clicks the "send" key.

## Easing Reserve Requirements

The Federal Reserve and the Comptroller of the Currency have eased reserve requirements for banks that make investments in venture capital funds and other nonfinancial companies. Under new rules the banks will only need to set aside in reserve capital an amount equal to 15% to 25% of the value of the investment. Thus, the greater the proportion of a bank's portfolio that is invested in equities, the higher will be the reserve set-aside requirement.

## COBRA Rules Clarified

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 102% 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.

## AICPA Issues Statement of Position No. 00-3

The AICPA has issued Statement of Position No. 00-3, "Accounting by Insurance Enterprises for Demutualizations and Formations of Mutual Insurance Holding Companies and for Certain Long-Duration Participating Contracts." The SOP provides guidance on accounting by insurance enterprises for demutualizations and the formation of mutual insurance holding companies as well as to stock life insurance enterprises that apply SOP 95-1 "Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises" to account for participating policies that meet the

criteria of paragraph 5 of SOP 95-1. The SOP applies to past and future demutualizations or formations of Mutual Insurance Holding Companies, and provides that applicable entities must apply the SOP no later than the end of the fiscal year that begins after December 15, 2000.

## Electronic Commerce Insurance

If you conduct business via the Internet, check your own liability insurance as well as that of major customers and suppliers to determine that there is protection for losses arising due to hackers or virus attacks that damage the system. Most policies offer very little, if any, protection. If you have risk exposure, consider obtaining an "electronic commerce insurance" rider to an existing policy or obtain a separate policy to cover your risk.

## Business Income Reimbursements

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:

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

## Employee Classifications

The Department of Labor is on the lookout for companies that classify workers as exempt under the Fair Labor Standards Act to save on overtime pay, even though the workers don't qualify. To be treated as exempt, an executive must: (1) direct the work of two or more people on a regular basis, and (2) be in charge of a department or other permanent unit, and have management as his primary duty.

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5. What is your current prior acts date: \_\_\_\_\_

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\_\_\_\_\_

6. Have you had a financial institution client since 1985:  
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3. Business Phone: ( ) \_\_\_\_\_ Fax ( ) \_\_\_\_\_

7. Do you perform S.E.C. work: Yes \_\_\_\_\_, No \_\_\_\_\_

Please Contact: \_\_\_\_\_

8. Number of: CPAs \_\_\_\_\_ PAs \_\_\_\_\_  
Staff Accountants \_\_\_\_\_, Bookkeepers \_\_\_\_\_, Per diems \_\_\_\_\_

4. Do you have Accountants Professional Liability? Yes \_\_\_\_\_, No \_\_\_\_\_

9. Gross Billings: \$ \_\_\_\_\_

Name of Carrier: \_\_\_\_\_ Renewal Date: \_\_\_\_\_

10. Had or *aware* of any claims? Yes \_\_\_\_\_ No \_\_\_\_\_

Deductible: \_\_\_\_\_ Limits: \_\_\_\_\_ Cost: \_\_\_\_\_

11. Do you perform any audits? Yes \_\_\_\_\_ No \_\_\_\_\_

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## Odds & Ends

Furthermore, the following managerial criteria must also be met:

- Have authority to hire and fire workers or influence the decision-making in this area.
- Be able to exercise discretion regularly.
- Spend at least 80% of his or her regular (40) work hours on managerial tasks.
- Not share responsibility with someone else for managing two or more workers.

Improper classification of workers as exempt, can result in imposition of back pay requirements as well as other penalties. Of course, the Agency and the IRS are also watching for misclassification of workers as independent contractors to reduce payroll taxes. Here, the key criteria consist of who has behavioral and financial control over the worker and the relationship between the employer and the worker.

### Section 125 - IRS Code

The IRS has issued final regulations increasing the number and types of events that may permit an employee to change coverage elections under a cafeteria plan pursuant to Section 125 of the Internal Revenue Code. The regulations add birth, adoption, effective loss of a body function or part, and death to the list of events that can trigger a mid-year change in elections of group-term life insurance and disability insurance coverage. The regulations also provide that an employee can change his or her election if the cost of benefits increases either due to a change in the total cost of the plan or due to an increase in the share of the cost borne by the employee. Mid-year elections are also authorized under the new regulations when coverage under the benefit option plan is significantly improved or a new benefit package is offered under the plan. The regulations indicate that a change in elections that is funded by salary reduction is prospective only, except for the retroactive enrollment required by the Internal Revenue Code in the case of an election made within 30 days of a birth, adoption, placement for adoption or death. The regulations became effective in January 2001, although the rules governing change in election due to a change in status apply to plan years beginning on or after January 1, 2001.

### Incentive Stock Options

The IRS has just announced that incentive stock option and options granted under an employee stock purchase plan exercised before January 1, 2003 will be free from the FICA and FUTA tax obligations. Similarly, amounts realized from dispositions of the stocks will be free from income tax withholding. In issuing the regulations, the IRS explained that it is imposing the moratorium on taxes to take a closer look at the appropriate tax treatment of statutory stock options because confusion has developed over differing definitions of wages for FICA and FUTA tax purposes and income tax withholding purposes. The Agency also hinted that future rules may not exclude statutory options from liability for Federal employment taxes, although amounts realized from dispositions may be exempted from income tax withholding. Employers may elect to apply the new IRS rules retroactively.

### Determining Reasonable Executive Compensation

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 compensa-

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tion 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.

### Sweep Accounts

Although sweep accounts are widely used, a recent survey of financial executives indicates that almost half the firms do not establish an interest earning sweep account in conjunction with their business checking account. Use of the sweep account enables a firm to earn overnight and weekend investment interest with respect to free balances on deposit at the bank.

### Implications of Borrowing & Depleting Employer Retirement Plan Assets

Separate studies indicate that 50% of employees take loans from their 401(k) plans, and that 68% of those who leave a job opt for a cash payout rather than rolling over the money to a plan of the new employer. These decisions play havoc with the accumulations in retirement plans and leave many people in dire straits by the time they are retired. To illustrate, if a worker is 25 years old and puts aside \$25 per week and obtain an average annual 8% return, by age 65, a sum of \$350,331 would have accumulated. Conversely, for another worker who takes out the contributions made in the 401(k) plan and then waits until age 35 to set aside \$25 per week in a new employer's plan, the accumulation by age 65 would amount to only \$153,197, even though only \$13,000 less had been contributed. It is extremely important for workers to be educated about the implications of a late start in paying in retirement contributions as well as about the impact of borrowing and depleting employer retirement plan assets. When we provide personal financial planning and retirement planning services for clients, we stress these matter and help people establish the discipline necessary for sound financial planning for the later years of life.

### Spousal IRA Contributions

A common mistake of taxpayers who have reached age 70 1/2 is to assume that they cannot make a tax deductible contribution to a spousal IRA for a non-working spouse

because they are barred from contributing to an IRA. The mere fact that one is ineligible to contribute to one's own IRA does not prohibit a contribution for the spouse so long as age and income requirements are satisfied.

### Noncompete Agreements

Noncompete agreement are commonly used to protect a company against the possibility that 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 that 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 that a legitimate contractual arrangement has been concluded, that will not be challenged by a court.

### "Wash Sale Rule"

The "wash sale" rule prevents a taxpayer from deducting a loss on the sale of a stock, if within 30 days of the sale, the person buys back the stock. The purpose of the rule is to prevent taxpayers from manipulating stock holdings merely to claim tax losses. But what if a husband and wife each have separate brokerage accounts and the husband sells a stock on which he had a loss. Then, within 30 days the wife buys shares in the same company in her brokerage account. Does the wash sale rule still apply? According to the IRS, under "wash sale" rules the husband and wife are treated as one, even though they maintain separate brokerage accounts.

### Credit Card Statement Audits

Most people don't question the charges shown on their credit card statement so long as they know that their card wasn't lost or stolen. But they may have a false sense of

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security. Some sophisticated criminals have managed to tap into the telephone lines used by stores to transmit credit card information to payment authorization services in order to steal vital credit card information such as credit card numbers, customer names, dates of birth, etc. The stolen data is then transmitted to accomplices in another country who use it to run up large purchases and make cash withdrawals. The only way to avoid paying for the erroneous charges is to maintain copies of documents underlying all charges you made and comparing them to the monthly statements. Unfortunately, many people don't take these precautions and wind up paying for merchandise they never purchases or end up in disputes with the credit card companies because they cannot substantiate the transactions they initiated and differentiate them from phony charges.

### IRS Approves Quarterly Transit Passes

The IRS has clarified that employers can provide transit passes to employees on a quarterly rather than a monthly basis at the beginning of each quarter. Thus, passes worth \$195 (3 x \$65) can be provided as a tax-free fringe benefit. However, if a worker's employment is terminated, the unused passes should be returned to the employer. If they are not turned in, the value of the passes covering the month(s) beginning after the termination date has to be included in the employee's income, and is subject to Federal income tax withholding and to FICA and FUTA taxes. In a separate ruling, the IRS has also indicated that firms can pay up to \$180 per month for parking at a non-temporary job site (one that is expected to last for more than one year) tax-free. It does not matter whether the employer makes the payment directly, or reimburses the employees. The benefit is better for employees who work at a temporary worksite, because payments or reimbursements are not subject to the \$180 limit.

### "Adoptive Parent" Redefined by IRS

New IRS regulations have expanded the definition of "adoptive parent" for purposes of being able to take advantage of various adoption related tax credits. Under old regulations, the credits were available only with respect to children placed for adoption by an authorized placement agency i.e. a state or local government entity and private adoption agencies, many of which have ties to religious and

public service organizations. This excluded taxpayers who were involved in independent adoptions from claiming the credit. Under new proposed rules which are to be in effect for taxable years beginning after December 31, 2000, an authorized placement agency would include biological parents and other individuals who are state authorized to place children for adoption. In effect adoptive parents utilizing private attorneys or other individuals who act as intermediaries between themselves and the birth parents or who engage in an independent adoption without intermediaries would qualify for the adoption tax credit.

### Small Business Overpay Alternative Minimum Tax

According to the U.S. Treasury, about 2,000 small businesses overpaid an average of \$11,638 in Alternative Minimum Tax for 1998. The reason is that they failed to take advantage of a provision in the Tax Reform Act of 1997 which exempted firms having gross receipts of no more than \$5 million for three consecutive taxable years from the Alternative Minimum Tax. An alarm does not go off to warn business people who are due refunds of excess taxes or to alert taxpayers of an overpayment. The Treasury release should be a warning to all small business owners, to utilize the services of a competent professional tax advisor or proceed at their own risk.

### IRS - Postmark Date Prevails

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.



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# Odds & Ends

## S Corporation

The Supreme Court has held that cancellation of an insolvent S corporation's debt passes through to its shareholders. The Court concluded that income from the cancellation of the corporation's debt, passes through to its shareholders as an item of income even though it is non-taxable, and increases the shareholders' basis in the company's stock. In turn, the shareholder may use the increased pass-through basis to free-up and deduct suspended losses which the owners can use to shelter other income from taxes. The IRS had unsuccessfully argued that the Court should treat the S corporation and its shareholders in the same way in which partnership are treated under the Tax Code. The Supreme Court's rejection of the IRS position places S corporations that are failing in an advantageous position over partnerships.

## IRS - Individual Tax Return Audits

The IRS individual tax return audit rate reached the lowest level since 1995, to just 0.49%. The Agency has expressed concern that the low audit rate leads to taxpayer non-compliance with tax regulations and has made a determination that too many resources are devoted to the bottom half of taxpayers who pay only 4% of income taxes. Accordingly, it plans to shift its resources to increase tax examinations of the upper-half of filers, enhance its return matching program by comparing K-1 forms with tax return of partners and S corporation shareholders, and put more personnel in the field by utilizing clerical personnel rather than agents to answer telephones. The shift will be made gradually over a 2-year period. If you fit the Agency's profile of a higher income taxpayer, expect more attention from the IRS.

## IRS Consolidates Computer Operations

The IRS has been consolidating its computer operations. From 67 mainframe computers at 12 locations, the Agency has trimmed down to 12 mainframes at only 3 locations. The new computers use newer and faster technology and provide more data storage and protection capabilities. From a taxpayer's standpoint the changes suggest that IRS personnel will have an easier time responding to taxpayer inquiries and the IRS audit personnel will be more effective in assessing taxpayer compliance with the Internal Revenue Code.

## Estimated Tax Rules for 2001 Have Been Changed

To avoid underpayment penalties, taxpayers with adjusted gross income over \$50,000 in 2000, must prepay at least 110% of the 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.

## IRS Uses Internet To Gain Info On Companies

The IRS acknowledges that it uses the Internet to gain information about companies it intends to audit. The surveillance is primarily of the company's web site, to assess information that may be useful in the audit process. Now it is broadening its focus to also include Internet surveillance of nonprofit organizations such as churches and charitable organizations to check whether their activities conflict with tax rules for nonprofit organizations, such as having unrelated business income. As more people get on the Internet, the IRS will undoubtedly monitor activities of individual taxpayers as well, to ferret out money laundering and other illegal schemes. If businesses or charitable organizations don't want to compromise their privacy, they should assess the information that's on their web site and its impact on maintaining confidentiality.

## Monthly/Quarterly Tax Deposits

The IRS ended the monthly tax deposit requirements for about 1 million small businesses at the beginning of the year. Companies that have less than \$2,500 in quarterly employment taxes can make their deposits on a quarterly basis. Formerly, the limit for quarterly deposits had been \$1,000 in quarterly employment taxes.





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