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THE ACCOUNTANT'S BUSINESS MANUAL

Volume 2

THE ACCOUNTANT'S BUSINESS MANUAL

A Two-Volume Service

Prepared for the AICPA by

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1. DEFINITION AND SCOPE OF E-BUSINESS

E-business is a rapidly changing area, with new terminology emerging continuously. IBM coined the term *e-business*, and others have picked up its use. In its narrowest sense, e-business is almost equivalent to the term *e-commerce*, which is the process of completing a market transaction electronically. From a technologist's viewpoint, e-business is often seen as the business use of any current technology tied to the Internet. Another definition is e-business is a set of business processes and systems that tie organizations together in all of their communications, transactions, and interfaces by means of Internet-enabled technologies, increasing value to each participant by reducing redundancies, trimming costs, and increasing productivity and timeliness. The Gartner Group suggests that e-business involves "the continuous optimization of a firm's business activities through digital technology." The authors suggest that e-business can be defined as "strategically utilizing technology throughout an organization to seamlessly integrate all business processes to facilitate the best possible customer experience." Such activities as digital communication, telecommunications, e-commerce, online research, customer relationship management, supply chain management, and enterprise resource planning can be placed under the umbrella of e-business.

E-business concepts not only relate to e-business practices, but also affect non-e-practices in other departments and functional areas within a company. As you read through the various concepts, you are likely to find yourself thinking about specific organizations and asking such questions as:

- How can this idea be implemented, given the current dynamics of a specific organization?
- How might this affect the roles of various key people within the organization, such as the chief financial officer (CFO)?
- Can these ideas, and the potential benefits that would result from their implementation, be effectively communicated to coworkers and management?
- How should the e-business concept improve the overall performance of the organization?

CPAs can most effectively plan for e-business challenges by first assessing their current roles. Are you in an organization planning or undergoing a transition to e-business? Are you in public practice with an interest in advising clients about e-business issues? Regardless of

your situation, if you are interested in knowing more about undertaking an e-business transformation, this chapter includes essential e-business concepts and the authors' approach to an e-business project. Whether you are in industry and are part of, or lead, the project team, or whether you are in public practice and provide your client services, everyone have plenty of opportunity to pitch in. If you are in industry, understand that it be difficult for you to perform your regular 50-hour-a-week job and take this on as well, especially if you are the project leader. If you are in public accounting and your client is undergoing an e-business transformation, you can bet that this project will spread your client's key people pretty thin. That means they likely will be looking for some outside assistance. If they don't get it from you, they likely turn to a competitor. So, now that everyone knows they can play a critical role, let's look at how e-business evolves so you can better assess your company's or client's current stage of development and anticipate subsequent phases.

1.1 The Stages and Technologies of E-Business

A typical organization experiences several stages of e-business maturity. At first, companies will struggle to provide employees routine access to services, such as access to e-mail and the Internet. New benefits emerge, and new problems arise with each new capability. For example, a company may need to limit employee access to certain Web sites and the amount of time employees spend online, and a company may need to determine whether employee online behavior should be monitored and e-mail use should be allowed for personal use. Most companies have long since solved these issues and realized the more savvy and comfortable their employees are interacting in an electronic environment, the more the organization benefits. Even though it is true that some people take advantage of loose company policies in this area, most organizations have found it better to allow the majority of the people to expand their technology-use comfort zones than to limit everyone's use to control a few (especially since those few are often uncontrollable regardless of the policies).

The next development phase is establishing a presence on the Web. Today, most companies have some form of Web site. Those that took the plunge early have redesigned their sites on average three to four times to augment site functionality. Typically the first initiative was to create a flat, static, informational Web site to reach the marketplace. Using dynamic content could keep the Web site looking fresh and avoid massive periodic redesigns, which tended to destroy any presence or recognition that had been achieved through the old site. Many early

adopters quickly broadened their concept of Web use from simply having a Web site to creating a Web presence that would reach potential customers 24 hours a day, 7 days a week, 365 days a year. Experience is the best teacher for understanding what works and what doesn't in this arena. Logically, the evolution into a Web presence is a road paved with both customer and employee feedback about how this resource can provide the greatest value.

Web sites are developed to provide the marketplace with external access to company information or to provide employees with internal access to corporate networks, called intranets. Early on, some companies opted to do little in the way of creating an external Web site yet made great strides with intranets. Intranets, like e-mail, can quickly change the way a business operates. In the best implementations, intranets have transformed the way workers communicate; created more consistency through one-source dissemination of corporate processes, policy, forms, documents, templates, and other items; enhanced the ability for groups to work together and collaborate; minimized redundancy of information and therefore misapplication of out-of-date information, and more. Overall, intranets have helped organizations achieve new levels of productivity and interactivity.

E-commerce is the next step in the typical e-business evolution. Many goods and services are easily described, sold, and delivered over the Internet. Although it was once thought that certain products would not flourish using this distribution channel, like the sales of coffee or candy because of the lack of certain sensory stimuli like missing aroma, the marketplace has proven otherwise. The Internet is merely another delivery mechanism, another channel, another touch point for companies to interact and do business with their customers—and it should be thought of as such.

A novice mistake made while implementing an e-commerce site is companies often confuse e-commerce with the fax machine. If you are going to use the Web, *use the Web.* That is, do not direct everyone to a telephone number or have them print forms that they then have to fill out and fax for processing. Using e-commerce means all the necessary steps required to carry out a transaction have been incorporated into the customer's experience. That includes estimating costs, such as shipping, providing alternative feature selections, delivering online help to assist in product/service selection, enabling the user to set up an account so they can buy the offering, tracking the order, and whatever else the users expect in order to carry out a non-e-transaction.

The good news about this stage is that CPAs, whether in industry or public, are called in. Why? Because this stage automates the business transactions, and that is the CPA's domain. It is important during this stage that you make sure the company executives see you as not only

someone who can automate the assembly line (so to speak), but also who can think strategically enough to consider revenue opportunities, increased service levels, and other benefits, not merely cost reductions and efficiency.

E-business is the final maturation phase in the cycle and, in its highest form, is characterized by partnerships and the automation of connections among an entire supply chain. Notice in this description, e-business is not about technology. It is about strategy to integrate all the processes, from the first contact with the customer; through the sales of products and services; through the scheduling, manufacturing, and delivery of those offerings; and through their continued maintenance and support. *E-business* is just another term for doing business today. Obviously, you can do business without any customer e-interactions, just as you can do business with only e-interactions. The most successful approach, however, is to thoroughly integrate all business processes and "e-ify" as many as possible to allow continuous customer interaction and access.

2. INTERNAL ISSUES WHEN IMPLEMENTING E-BUSINESS

As you can quickly see, because e-business affects all aspects of an organization, it follows that an e-business team should be created to represent all the major areas in an organization. The best e-business team represents a cross-functional slice of the organization. Some people come from information technology (IT), of course, and might include programmers, analysts, database managers, and system administrators, depending on the organization's size and technology capability. Marketing must be represented because the Web has proven to be a significant marketing medium. And the list goes on. Customer service, accounting, production, warehouse/shipping, public relations, corporate, and many more departments within a business need to be represented if the identified solutions are to be embraced, supported, and implemented throughout the organization.

An e-business team leader needs to be appointed. A leader is someone who can work with all types of people, understands technology, and can manage large projects, but most important, a leader understands the business's processes and the transactions they generate. This e-business team leader commonly is chosen from accounting or IT, and even though the strengths of each are obvious, both groups have their weaknesses. Often, the IT person is overly enamored with the technology rather than the business strategy. Remember, e-business is not just about

the technology, which is an enabler. The business strategy, however, is most often rooted in creating additional customer loyalty, retention, and value, and has to be the driving force if the effort is going to be successful. On the other hand, while accountants are often a great choice because they know the business process and transactions and have a broad understanding of technology, there is a risk here, too. The accountant too often focuses too much on streamlining processes rather than utilizing technology to create strategic advantage. So, generally speaking, if you are a CPA, consider the following:

The good news is that:

- You love to cut costs,
- You get excited about efficiency, and
- Process and procedure are your favorite tools.

The bad news is that:

- You tend to automate first those functions that consume your department's time rather than make the company money, such as general ledger over inventory.
- You think that anything having the word *revenue* in it is a responsibility belonging to the marketing department (or someone else).
- You think of customer service as a cost center rather than your best bet for repeat and/or increasing business.

In most companies, those who keep the customer top-of-mind in all their discussions rise to the top. Those who keep the company running smoothly hit the glass ceiling just below the top executive tier. So, as a CPA taking on a project such as e-business, leverage what you are good at, but balance your natural urge to "operationize" everything with the need to optimize strategic advantage.

If you are wondering what we mean when we use the term *strategic advantage,* think of Hertz and its development of the Gold premier membership program years ago. Hertz used technology to allow the bus driver to alert the rental counter that the traveler had arrived, so Hertz personnel could begin verification that the car and paperwork were ready, so that the traveler could immediately drive the car off the lot. Hertz also used hand-held devices providing almost instant check-in with a receipt on the traveler's arrival back to the lot. All rental car companies were performing these business processes, but only Hertz found a way to create a strategic advantage by simultaneously saving the traveler precious time, providing instant necessary documentation, and streamlining the processes. This higher level of personalized service was more than enough for many frequent travelers to shift all their business to Hertz. So, not only did the company create more customer

loyalty and improve retention, Hertz also benefited with increased volume. To deliver an effective e-business solution, therefore, you have to strike a balance between technology and strategy, between functional areas within the business, and between corporate and customer objectives.

Now, back to creating your e-business team. In addition to creating the team, you need to establish an approval body to review their work. If you are a small to medium-sized business, the e-team should likely report directly to executive management. However, if you are a medium-sized to large business, you should set up an approval body that should also be cross-functional and perhaps organized as a steering committee. All related projects should be estimated, approved, and ranked according to priority for the e-business team. There should be one executive sponsor, an executive-level person who acts as the champion and evangelist of the entire e-business effort. Obviously, the executive management team should be involved at some level because e-business decisions directly affect an organization's ability to achieve its strategy.

At this point, we have identified our e-team members, have a steering committee if appropriate, and are ready to begin "e-ifying" your business. The first course of action is to get them all together and conduct a planning retreat to establish the team's mission, objectives, priorities, and budget.

2.1 The Retreat

The retreat should be conducted in an interruption-free setting, preferably for a day and a half to two days. If this is not possible, set up a series of sessions, with each lasting a minimum of two to three hours. This is important because it takes 30 to 45 minutes for everyone to relax and begin a meaningful dialog. With this in mind, let's begin our basics review.

The first step is to define what you are trying to accomplish with this e-business initiative. To do this, you need to consider what is important to the company and what is important to those it serves. This works out to be similar to your company's current mission statement, but narrowed to just focus on the e-business team's project. Consider the following example of a credit union's e-business team's mission statement:

> The mission of the e-business team is to develop an infrastructure that allows access and services such that the normal banking transactions of our members can all be managed without ever coming to our facilities and, for the most part, be done easily and securely from their home or office.

Short and sweet, this set the tone for what the credit union's e-team needed to accomplish. Considering the mission statement, the first focus was to identify what services the members currently use, as well as those they want to use. Next, the e-business team needed to evaluate their technology's current capabilities. Then, the team compared those capabilities to the service-set they desired, to identify gaps. Finally, a plan to fill those gaps was created.

Don't misunderstand: The mission statement is not the answer to an organization's problems. We are saying, however, that it marks the beginning of *plan accountability.*

> *Plan accountability* is a framework that promotes consistency among all the elements of a plan, from the mission through specific goals, plans, objectives, and tasks.

Consider our credit union example. If one of the objectives identified from this process was to create a way of consolidating the reporting of all of a customer's investments, the first question someone should ask is, "How would this new consolidation reporting service deliver the mission statement promise of *providing access and services to all the normal banking transactions of our members*?" Assume the answer was that the e-business team wanted to become the members' one-stop-shop for all their financial needs; the idea may be worthy of pursuit, but it is inconsistent with the priorities set by the mission statement. On the other hand, if the answer was that most members had retirement accounts with the credit union, and had made it clear that consolidation of all of those accounts to better manage their scattered assets was a priority, the story changes. The mission statement provides a kind of sanity check to make sure the initiatives being considered are in line with what you want to accomplish. This helps you avoid the resource depletion that occurs when projects constantly veer off course.

The reality of business today is that too many projects get sidetracked because they try to take advantage of a short term opportunity while treating their long-term strategic advantage as an unwanted stepchild. Plan accountability is the process used to verify that the mission, goals, and plans of an organization are consistent. And when they are not, either change the goals or change the mission. For example, if a primary objective of the credit union's e-business team was to become a one-stop-shop for all its members financial needs, this idea should be reflected somewhere in the e-business team's mission.

At this point, the emphasis shifts to the identification of the steps necessary to achieve the mission. This leads us to the goal and objective-setting portion of the planning retreat. To determine the organization's goals, establish break-out groups and pose the question:

What should our team's top three to five objectives be?

Why just three to five? Because an objective (or goal) is a very broad definition, such as "Provide best of breed online banking functionality, such as statements, and transaction postings, bill-paying functionality," or "Develop access to cash so the average member pays no fees with only five minutes of travel." These are not easily or quickly accomplished. They usually take numerous actions to complete, too. When you open up planning to as many objectives as you can identify (seven to even a dozen or more), you find that there not only becomes a wide disparity between their relative importance, but you also quickly overload the team with more work than can be realistically completed.

When looking for your three to five objectives, give careful consideration to the mission statement. For example, the credit union's e-business mission statement contains the phase "develop an infrastructure that allows access and services so the normal banking transactions of our members can all be managed without ever coming to our facilities," which is most likely the foundation of the objective-setting process. For example, one objective is likely to be around "building the infrastructure," another around "determining what the normal banking transactions of our members is (both today and in the near future)," and finally, finding a way of "delivering those services without every having to come to the bank." By taking the time to decide what this phrase really means, you begin to break this mission down into objectives, plans, and tasks. Answer such questions as:

- What online access do our members want and expect?
- What online capabilities do they consider important when choosing a financial institution?
- What parts of our infrastructure can we build upon, and what parts do we have to rebuild?

The purpose of this process is to uncover what e-capability your team wants to build to ensure the future success of your organization. Therefore, staying with this same logic, after you have identified your objectives, propose an action plan for each one. Additionally, everywhere appropriate with each objective and action plan, you need to determine progress checkpoints to make sure your project comes in on time and on budget.

Now that the retreat is over and your team is comfortable with its mission and objectives, two efforts need to be considered. The first is, "Do you know enough about the company's performance and its customers' motivations to develop effective business solutions?" Most groups need to do a little research in this area to set the team members

to the same perspective. The second initiative is to understand the current business processes and the systems supporting those processes, and identify the gaps. We discuss both, but we start with how business intelligence and tools for making decisions can provide insight as to how to approach this complex project.

2.2 Business Intelligence and Tools for Making Decisions

Accurate and timely information is crucial to any business and helps managers make better decisions. Using good business intelligence as the foundation for the many decisions that have to be made in a project this complex is critical. It is also important to take advantage of the many tools available to assist you in such a task. For example, a decision support system is an interactive, flexible, computerized information system that enables managers to obtain and manipulate information for the purposes of decision making. Also, the Internet and the World Wide Web can be very useful in gathering necessary information. (To learn more about the differences and the relationship between the Internet and the greater World Wide Web, refer to the "Did You Know . . . ?" section on www.webopedia.com.)

Business intelligence must rely on several sources of information. We discuss the role of internal company records and secondary data from public and private sources, as well as primary data generated through marketing research.

2.2.1 Internal records

Internal records provide an important source of information for decision makers. The accounting records provide sales, cash flows, expenses, and profitability data important for evaluating management and marketing effectiveness. Records of online sales can be compared to advertising expenditures in different media to assess the effectiveness of each. Ordering and inventory information can help improve delivery time and accounts receivable cycles. As accountants, using this information to set performance metrics, quantify company objectives, and create key operating statistics is second nature to us. In this context, however, we need to think about what outcomes we should expect from our e-business effort and create metrics for evaluation. For example, if your sales have been growing at a rate of 15 percent for the past three years, how are you anticipating this to change given that you are adding this additional e-channel? Another example might be if your cost for servicing your customers is currently at 20 percent of sales, what are you expecting those costs to be by adding a self-help customer center?

Even though your overall costs are likely to go up, it's hoped your customer service-cost-to-sales falls with the launch of this support alternative. There are literally hundreds of identifiable and quantifiable metrics, depending on the objectives of the e-business project, that have their baseline in your current internal records.

Another important internal information category is that of individual customers and their activity. At a minimum, customer databases should include customer names, contact information, and purchase history. Online storage and retrieval techniques have facilitated the growth and use of customer information. Many online sites require the visitor to register and then all contacts can be tracked. A company might have information about inquiries, purchases, calls to customer service, and the response to special promotions and offers.

Many Web sites track movement and navigation as users browse from screen to screen. This tracking can collect information about time on site, time per page, and the path taken through the Web site. In addition, a company can often identify the Web site that the user visited immediately before and after its own, the type of browser used, and geographic origin of the request. This information can be used to improve content and organization of Web pages and can give some insights about the competition that your customer is visiting. This data is generated automatically in Web site logs and can be very useful.

2.2.2 Secondary data

Many outside sources of information exist and should be used when the needed data is not available from the firm's internal records. Secondary data is information that has been previously collected, often for reasons unrelated to the decision at hand. Using secondary data can save time and money, and should always be consulted before initiating primary research. The secondary data may help solve the researcher's problem, or it may help to frame the problem statement and suggest an appropriate approach to a primary research project. The disadvantage of secondary data is often that there is a mismatch between the unique problem of the researcher and the purpose for which the secondary data was gathered. Further, secondary data may not be up-to-date and the collection process is often unknown, which may affect the data quality. Gathering secondary data has traditionally been tedious and frustrating. Researchers often had to make many trips to the library and wait weeks for information from government agencies, trade organizations, or other sources. The Internet has eliminated a significant amount of the legwork associated with the collection of secondary data.

2.2.2.1 Public information

A great deal of information is available from public sources on the Internet. Most U.S. government organizations provide online information in their respective specialties. For example, census information, patent office procedures, economic analysis, transportation statistics, and agricultural trends can all be found at various government Web sites. International organizations such as the World Trade Organization or the International Monetary Fund are good sources of information about countries other than the United States.

Other sources of public information include university libraries and their periodical newspaper and book databases. Some can be accessed via the Internet and others through the local library's Web site. A great deal of industry-specific information is available at literally thousands of specialty association Web sites, and most of it is free to visitors. A good way to start a search is by using a major Internet search engine, such as www.Google.com or www.askjeeves.com, or directories such as www.yahoo.com. More than 80 percent of Internet users find the sites they are looking for through search engines, and 57 percent of Internet users search the Internet everyday (source: www.searchenginecolossus.com/).

2.2.2.2 Privately generated information

Many companies and individuals post relevant information to Web sites. Company Web sites often provide insight into the mission, products, partners, organization, personnel, and current situation. Universities, politicians, and individuals create Web sites containing commentary and other useful data. Large research firms, such as Forrester Research, are a good source of information, because they post summary or sample statistics on their sites as a means of encouraging the purchase of full reports. More specialized sites include the Gartner Group and IDC for e-business, Jupiter Communications for Web advertising, and Comscore for Internet audience measurement services that report details of Web site usage, including site traffic, intensity, and visitor demographics.

For stories about U.S. population characteristics and social and cultural trends, American Demographics and Marketing Tools can be very useful (www.demographics.com). Finally ZDnet is an excellent source of articles about technology, including product reviews and comparisons (www.zdnet.com).

Another important source of privately generated information comes from news aggregators, such as www.bizinfo.reuters.com or www.newsdesk.com. These are firms that monitor a number of media sources, presenting selected stories to users either by sending stories to the user's inbox via e-mail or by allowing users to take it from a specially tailored Web site.

2.2.2.3 Information quality

It is important to be cautious when using secondary data for decision making because it has many limitations. This caution is especially important when using information found on the Internet for several reasons. Anyone can publish on the Web, and there is often no review process equivalent to the editorial process provided by other media publishers. There is no organization providing oversight to the content of the Internet or monitoring data accuracy. According to Strauss and Frost (2001), the following steps can be taken to evaluate the quality of secondary date found on line:

- *Discover the Web site's author.* A site published by a well-known organization is more credible than one published by an unknown author. Sometimes the site names can be misleading, making it difficult to determine the source of the information. Once the author is identified, try to determine that author's level of expertise.
- *Determine how current the Web site's information is.* Some Web sites change every day, and others have been neglected for years. Checking the hyperlinks is one way to assess how up-to-date the Web site is. A site with many broken links is a site that has probably not been updated recently.
- *Consider how comprehensive the coverage of the topic is on a particular Web site.* Some Web sites are very narrow in focus and may not give a broad enough treatment to put the information in context.
- *Determine accuracy.* Accuracy is of primary importance, and it is always wise to try to validate the data by locating similar information from other sources, either on the Internet or from hard copies at the library.

2.2.3 Primary data

Primary data is information you collect through original research or surveys to solve a particular problem. Usually it is wise to search for secondary data first, because collecting original or primary data is expensive and time-consuming. The advantages of primary data are that you know it is current, and it can be collected in a way that is directly relevant to the problem or decision at hand. Further, it is proprietary information that is not available to competitors.

The Internet has affected the primary data collection process in many ways. Using digital technology, it is possible to collect information about how long consumers spend shopping, what advertisements they open, and the path they take through a Web site. The Internet has made the use of customer and employee surveys efficient, rapid, and low-cost. The administrative effort alone to prepare, send, compile, and

report the results of surveys used to make it too difficult for most small businesses to conduct surveys. Services such as www.zoomerang.com have changed all that because in a matter of hours, a complex survey can be put together and distributed via e-mail, with the results automatically tabulated over the survey period, for a yearly subscription fee of around $600 dollars. This fee allows you to create as many different surveys as you want, with the right to send out 10,000 total surveys during that period. This allows businesses to gain critical perspectives and insights from employees and customers for less cost than the postage alone using the traditional paper surveys.

By using e-mail surveys and pop-up ads, gathering information from consumers on a very large scale has become practical, as well. "For example, every twenty-four hours AOL subscribers are invited to participate in a short survey. The company collected about two million responses from consumers over a period of eighteen months and used this data to evaluate it customer support." (Krishnamurthy, 2003, page 270) Consider sites such as www.startsampling.com, an organization that lets you get consumer feedback from your members as they sample your product or provide you personal insights into the habits.

"Clickstream data is the record of an individual's movement through time at a Web site." (Krishnamurthy, 2003, page 279) Analysis of clickstream data can be used for path analysis, advertising effectiveness, and shopping cart behavior. Path analysis involves clustering consumers on the basis of the route taken to get to the site and the path used to navigate within the site. This can answer questions such as how many clicks it took to find the desired information, as well as what site the user came from and where they went after leaving your site. Advertising effectiveness is another common application for clickstream data. It can be determined whether the user clicked on a banner ad or responded to an e-mail, which helps a firm assess the effectiveness of its marketing communications. Shopping cart analysis is another useful application for clickstream data. One problem many retailers face online is that a large proportion of online shopping carts are abandoned after items have been selected. Using clickstream analysis may help to determine what customers were interested in, what caused them to lose interest, and when they left the site.

2.3 Identifying the Gaps in Current Process and the Systems Supporting Them

This step is not nearly as difficult as it might at first seem. One of the problems of using a term such as *e-business* is that most accountants' first instinct is they need to get a technology specialist to take on the

project. Although this may be true because of your limited bandwidth, it is certainly not necessary. You need to know little about technology to perform this analysis, but it is helpful to know a great deal about the business itself.

The authors like to start by flowcharting the processes, from first customer contact, through delivery of the product or service, to any ongoing support of that product or service after the sale. If you have never done a flowchart, that probably works in your favor. We are not looking for the technically accurate use of symbols or the latest implementation on flowchart presentation. We are looking for a simple roadmap to who does what, and at each step, what transactions or paper are created, what processes are initiated, and what resources are committed. As was said well in the tag line of the movie Jerry Maguire, "Show me the money," for the e-business team, the tagline is "Follow the transactions." So your process may start with, "Order desk receives a phone call from a new customer" as the first box, which leads to three branches: "New customer wants information," "New customer wants an engineer to visit and determine feasibility of product/service solving the problem," and "Customer wants to order a product." It is simple. You just trace what happens, what choices occur, what paper is created, what money is transferred, and what resources are allocated.

In this process, you find multiple entry points. For example, in this case, we started with a customer calling. What about when a sales person calls on prospects? How about getting a response from a flyer you sent out? Or maybe you get an e-mail from someone who visited your brochureware Web site? The point is, while the job of flowcharting everything is simple, what makes it difficult is identifying all the points of entry, all the deviations that occur in normal day-to-day business, what really happens rather than what is supposed to happen, and so much more. This step may be one of the most enlightening within the e-business project. Notice how much of this discussion was about technology. As we stated earlier, the step is all about how the business is transacted.

Once you have a pictorial view of how the business works, the next step is to look at the various systems supporting each process. For example, some processes, such as inventory management, are likely supported by an industry-specific software application. Such processes, however, as scheduling, quality control, warranty, and many others might be supported by manual processes, department-developed spreadsheet templates, custom-written applications, or some combination.

Next, on your flowcharts, highlight the various processes supported by each automated solution. What remain (items not highlighted) are all of the manual processes that fall outside of the installed systems.

What is also evident is how many processes are supported by partially or marginally automated approaches. It is important here to keep your mission and objectives in mind. You don't necessarily have to automate everything. Because of the costs and rarity of certain transactions, you might have to isolate certain exceptions and handle them outside of your e-business system. For example, for a specific set of customers fitting a unique profile, you might direct them to call a special number for assistance.

Several benefits come out of this exercise. First, the authors have never gone through this detailed review without identifying numerous areas for process improvement. "Process improvement" may sound very sophisticated, but the improvements almost always come from the discontinuance of duplicate, out-dated, or useless functions. In addition, when partially or marginally automated approaches are supporting critical or strategic capabilities, bringing this into clear view of the executive team creates needed resource reallocations.

Now, it's time for the e-business team to identify the gaps in automation, processes that need to be automated, and automated processes that need to be integrated. The basis for this gap analysis is rooted in the mission and objectives outlined previously. The team, logically, does not have to worry about the automation and integration of processes outside the scope of their project. However, good project planning includes integration points, so many of these skipped processes can be easily incorporated later.

Let's come back to the author's definition of *e-business:* "strategically utilizing technology throughout an organization to seamlessly integrate all business processes to facilitate the best possible customer experience." Given this and the project's mission and objectives, the team needs to lay out the steps necessary to provide that exceptional customer experience and supply all the links, integration, user interfaces, and support necessary to achieve it. For example, if one of the objectives is to be able to provide shipment tracking, not only does the e-business team have to design and develop the user experience and the Web interface to be able to track and review the progress of the shipment in question, but the internal systems also need to be integrated so status reports from the drivers are instantly available anywhere in the system as soon as they are received.

"E-ifying" your business, most often, forces you to tear apart and rebuild the many band-aid solutions that have been placed in service over the many years as short-term fixes to the at-the-time chaos. Thousands of these solutions are in place at any time with almost every business of any size. These band-aid solutions almost always cost the company in one or more ways, for example, extra money, resources, quality, customer satisfaction, timeliness, and more. So, typically, the

e-business team is set up to be heroes as they unveil the reality of what really happens day in and day out within the organization.

3. MARKETPLACE ISSUES WHEN IMPLEMENTING E-BUSINESS

Our e-business team is focused on implementing corporate strategy, streamlining processes, using technology to seamlessly integrate the organization's transactions and interactions, and it has done research to better understand its customers and determined the appropriate company metrics to evaluate the results of their e-efforts. Now it's time to look at how you can better e-connect to the marketplace. Let's start this discussion by reviewing some e-business models. Next, we want to look at techniques for communicating online. And finally, we discuss how and why customer relationship management has to be a cornerstone in our e-business foundation.

3.1 E-Business Models

An e-business model describes a method of operation that enhances a company's profitability by supplying revenue or by controlling costs while offering greater value, access, and/or appeal to the consumer. The popular press has created and popularized many new terms describing e-business models, but most models are rooted in existing business concepts. In this section, we discuss six different models. The first three are content sponsorship, direct selling, and online retailing. These three models represent popular ways that businesses sell directly to customers using e-marketing. Another model, infomediary, might best be described as an intermediary that aggregates and sells information. Next to be discussed is the intermediary model, which involves many kinds of middle-men that position themselves between sellers and buyers, presumably adding some sort of value to the transaction. Finally, we review the newest model, which is aggregator or portal, which is some combination of all five.

3.1.1 Content sponsorship

The content sponsorship model revolves around the creation of a Web site that attracts visitors interested in the information or activity provided. Online content may educate, entertain, or provide convenient tools for the consumer. Content sites sometimes provide an opportunity for a digital community to develop where users can discuss topics and

compare experiences. Many content sponsorship businesses built their customer base by giving their basic service for free. This was often done to build market share and starve out competitors. The intention was to build a loyal customer base and then sell advertising space to companies who wanted the attention of the same customers. The content sponsorship model can be compared to television, magazines, or other media that sell print space or airtime. Often, the content sponsorship model is used in combination with other models to generate more revenue. For example, many content sponsors sell products and services to their customers who use the Web site's free services.

3.1.2 Direct selling

The direct selling model involves the manufacturer selling directly to the consumer, bypassing wholesale and retail channels. Direct selling results in a shorter distribution channel and the elimination of intermediaries. When this model is successful, it can result in huge savings in sales-related expenses for the producer. The manufacturer can capture some of the margin that previously went to the intermediary. Dell computer is a famous example of a very successful direct-selling model that targets both businesses and the consumer. The direct selling model also offers benefits for the consumer in the form of lower prices, and possibly faster delivery.

There are also disadvantages associated with the direct selling model for both customers and producers. The producers must assume responsibilities for communicating with customers and serving many individuals rather than a few intermediaries. In other words, they must perform some of the functions and support traditionally offered by wholesalers and retailers. This model might also disenfranchise many loyal intermediaries so they discontinue relationships with the manufacturer, thereby negatively affecting overall sales volume. On the customer side, they may incur higher search costs to locate products, spend more time interacting with multiple manufacturers, and/or inadvertently overlook key integration, training, and support products or services that were bundled within an intermediary's offering.

3.1.3 Online retailing

One of the most well-known models on the Internet is online retailing. Organizations create a Web site that offers goods and/or services for sale to consumers and businesses. What differentiates this model from the direct selling method is that the online retailer offers products from a variety of manufacturers, similar to the traditional retailer. Online

retailers range from pure play Internet organizations, such as Amazon.com, to traditional retailers with a complementary Web presence, such as Walmart.

3.1.4 Infomediary

An infomediary is an organization that assembles and distributes information. Infomediaries act as a filter between organizations and consumers. One type of infomediary is a marketing research firm. Normally the infomediary pays the consumer for sharing his or her information and then resells it in the form of marketing research reports on various topics, such as shopping habits or product preferences. Some marketing research infomediaries obtain the information covertly and do not compensate the consumer. This is done through the use of such techniques as cookies, which track users and record the Web pages visited as they navigate the Internet.

Another type of infomediary is a permission-marketing organization. In this scenario, the consumer agrees to receive messages from advertisers. The permission marketer compensates the consumer for access to his or her computer screen. The consumer may receive money, points toward shopping, or free Internet service and must share demographic and other personal information with the permission-marketing organization. The permission marketer then resells this information to advertisers that are trying to reach a particular demographic or psychographic profile. The benefit to advertisers is they have an opportunity to communicate with a very specific target market of consumers who have expressly agreed to receive those messages.

3.1.5 Intermediary

There are two broad categories of intermediaries; brokers and agents. The broker creates a market space where buyers and sellers complete transactions, but the broker never takes possession of the items for sale. The broker usually charges the buyer or the seller a fee based on the transaction, but they typically don't represent either party. What the broker provides is information or negotiation services that help both parties complete an exchange of some type. Exchanges and auctions are the best online examples of the brokerage model. Other examples of online brokerage services are exchanges such as Ameritrade and E*Trade for stocks, and Autobytel and Carpoint in the automobile category.

Agents, unlike brokers, do represent either the buyer or the seller, depending on who pays the fee. Selling agents represent one party and usually earn a commission for each sale. Manufacturers' agents represent more that one seller. On the Internet, manufacturers' agents

are often called seller aggregators because they represent many companies on one Web site. A familiar example is the many travel reservation sites available online. These travel sites can be classified as aggregators because they are paid commissions by the airlines and hotels they represent.

A shopping agent represents a buyer rather than a seller. Shopping agents are Web sites that allow a consumer to search for and display lists of merchants that sell a particular product as well as the prices at which they sell them. Shopping agents can also allow the consumer to specify attributes other than price in their search. For example, consumers can compare shipping policies, return policies, and product features and rate each on a scale from "not important" to "must have." Shopping agents help individual buyers obtain the prices and value they desire quickly and efficiently. The site www.activebuyersguide.com is a great example of this.

3.1.6 Aggregator or portal

A final business model just beginning to emerge is electronic portal to a specific market segment. Although this category could technically be called an intermediary, the authors have created a separate category for it because of its likely future significance as well as the fact that it is usually a combination of all the models previously discussed. Portals often provide content to a specific market segment, have an online retail store with a variety of offerings from other manufacturers, direct sell their own products and services (which might be services allowing disparate products or services to more seamlessly integrate with each other), act as an infomediary to both the market segment they serve as well as other vendors desiring access into the market-segment channel, and as an intermediary. Well-known technology research groups such as IDC have been espousing the value and long-term importance of these models, but few have found the success required to fulfill the promise at this time. However, portals should come of age over the next few years as various technologies continue to evolve and because of company efforts from organizations such as Microsoft, who have bet the company strategy on this model.

3.2 Marketing Communications Online

The Internet is a powerful tool for communicating with the company stakeholders: employees, customers, shareholders, suppliers, and others. Marketing online consists of several different types of promotions, including advertising, public relations, and sales promotions. Advertising is any form of paid communication in which the sponsor or company

is identified. The content is usually persuasive in nature and seeks to advocate a product, service, or idea. Pop-up and banner ads are currently the predominant form of advertising on the Internet, but other forms such as sponsorships are also important. The marketing function that evaluates public attitudes and executes a plan to earn public understanding and acceptance is called public relations. Many companies have Web sites that serve as public relations vehicles. Sales promotions are usually intended to stimulate purchasing in the short term and include coupons, free samples, contests, and special offers. Examples of all of these techniques can be found online.

3.2.1 Advertising online

Advertising can be used either to build brands or to elicit a response from the potential customer. The focus of brand advertising is on building the brand name, rather than on immediate sales. In contrast, direct response advertising is designed to create action on the part of the consumer. The action might be a simple inquiry or an actual purchase. Research has shown that the Internet can be used effectively for building brands. (Cyber Dialogue as sited at www.emarketer.com). The real advertising strength of the Internet, however, is for direct response communication because of the unique opportunity for two-way communication with consumers. Traditional advertising, such as print and television, provide a one-way communication from the company to the consumer. The Internet allows the consumer to respond immediately to the advertisement.

3.2.1.1 Banner ads

Banners are rectangles placed around the edges of Web sites. Banners come in many sizes from small buttons to very large ads that occupy a significant portion of the screen. When users click on a banner, they are automatically linked to the advertised Web site. Three interesting types of banner ads are pop-ups, pop-unders, and interstitials. Pop-up ads appear abruptly when a consumer first visits a Web site or at any point while browsing the Web. Pop-under ads open in a new window that is visible only when the user closes the current window. An interstitial banner ad occupies the entire computer screen and appears when a user moves from one Web site to another. The user must initiate closure of interstitial, pop-up, and pop-under ads. The advantage of such ads is that the user is surprised and the response rates, at least initially, were better than for traditional banner ads. The downside is that consumers have become annoyed by the intrusive use of pop-up, pop-under, and interstitial ads. Some consumers install software designed to defeat these intrusive ads, thus making it harder to reach

consumers with a marketing message. For banner ads to succeed, they must have two characteristics. The first is the ability to attract the user's interest and the second is a clear call to some desired action. The banner ad must take the user to a Web site where the desired action is clear and easy.

3.2.1.2 Sponsorships

Unlike banner ads, which are placed on many different Web sites, sponsorship is a long-term promotional agreement with a few sites. The key purpose of a sponsorship is to benefit from the traffic and brand strength of a Web site in the hopes of gaining traffic to one's own Web site. The most popular sites for sponsorships are the portal sites such as AOL and Yahoo because of the popularity of these access points to the Internet. Smaller more specialized Web sites may offer the advantage of more specially targeted groups of consumers.

Sponsorships are increasing as a method of advertising on the Web because they often integrate editorial content and advertising. This approach is popular with advertisers because it gives them additional exposure and offers the impression that the site endorses the product.

The downside of the traditional sponsorship relationship is the number you can have. If you have too many on your site, the sponsors don't feel they get the attention and endorsement that they are paying for. In other words, the visual landscape becomes too crowded. For the organization being paid by the sponsors who are looking for more revenue opportunities, they naturally want more ad-space paying customers. "Where there is a market, there is a way," and "sponsored links" are the newest evolution. For example, if you do a search on computer-based training on www.google.com, you not only see those listings matching the search criteria, but on the right-hand side, you see a number of training developers and tools listed for easy access. Even though this type of sponsorship does not provide the level of visibility and perceived endorsement that traditional sponsorships have, it does create many more advertising alternatives and, in this case, selective endorsement by specialty area. We don't know how effective this approach is, but we do know it has some positive impact because the authors have used these links on numerous occasions to find products or services.

3.2.1.3 E-mail advertising

E-mail is the least expensive form of online advertising and is usually in the form of text sent to a large list of individual addresses. It is inexpensive compared to its closest equivalent—direct mail—because there is no postage charge, no paper costs, and very little handling, and it can be automatically personalized. E-mail ads offer a convenient

way to direct users to Web sites using hyperlinks and offer a means of two-way communication between the customer and the advertiser. The disadvantages of e-mail advertising are the potential for alienating consumers barraged with unsolicited and unwanted e-mail—what is known as "spam." Spam's negative effects can be somewhat reduced by using highly targeted mailing lists so consumers receive messages that interest them. E-mail distribution lists can be generated in-house from Web site registrations, subscriptions, or purchase records. Highly targeted e-mail lists can be purchased from list brokers. Usually the list broker sends the advertising message to the purchased list, rather than turning over the list. The best lists are ones made up of individuals who have opted in, that is, signed up to receive commercial e-mail about products that are of interest to them. Research has shown that lists with members who have opted in get much higher response rates than those who have not. According to Strauss and Frost (2001), opt-in lists can generate response rates as high as 25 percent. Compare this to the 1 percent response rates for banner ads.

An interesting variant of e-mail advertising is something called viral marketing. This happens when users forward e-mail to others on their e-mail lists, thus extending the reach of the ads. Viral marketing has been compared to word-of-mouth advertising, but is much more powerful because contacting friends using e-mail is much faster than face-to-face or phone conversations. It is almost as easy to send an e-mail to 20 friends as to 1, especially if distribution lists are already in place.

3.2.2 Public relations online

Public relations is used to create goodwill for a company among a number of different groups. The targets of public relations messages include shareholders, employees, media outlets, suppliers, the local community, and customers. Web content designed to create a positive attitude toward the company or its brands can be called public relations. Many companies provide Web content that is meant to entertain, inform, or persuade. Some corporate sites feature information about products or the company without interactive features. These sites are often called brochureware. They are the digital equivalent of public relations brochures placed online. One advantage is the low cost of establishing a Web presence using brochureware. Another advantage is that information can be disseminated more quickly and at reduced cost compared to traditional methods. Press releases and corporate reports can be placed on the Web site and are available for shareholders and the public. Instruction manuals and corporate newsletters can be placed online so they can be accessed by customers or employees.

Online posting can save time and money by eliminating the need for printing and distributing materials.

Interactive Web sites can also be useful for public relations but are more expensive to create and implement. Often users visit Web sites looking for information. A well-designed interactive site can simplify the user's search for the required information. For example, a site might include a location finder to assist users with locating a dealer in their area. Users might be asked to input their zip code and the site then returns a list of nearby dealers. This is a far better solution than presenting a long list of dealers for the users to wade through.

3.2.3 Sales promotions online

Tactics designed to get an immediate response from the customer are often categorized as sales promotions. They are different from advertising because they lead to an immediate increase in sales and they are usually time specific. In other words, they are usually available for a short period of time. Examples include coupons, rebates, product samples, contests, and special offers. "Marketers report three to five times higher response rates with online promotions than with direct mail." (Strauss and Frost, 2001) Online coupons may be more effective than traditional paper coupons. The most common way to distribute coupons has been through the Sunday newspaper. Interested consumers had to comb through hundreds of coupons to find the few that were of interest to them. The redemption rate of newspaper coupons has been about 1 percent or 2 percent. Online, the consumer has a better chance of easily locating useful coupons by simply searching for the product of interest and related coupons can be printed just before shopping. Thus online coupons should result in higher redemption rates than traditional coupons. Sales promotions online are often combined with advertising. When consumers register for a promotion, their name and e-mail can easily be added to the company e-mail database. These names can then be used for future communication with prospects and customers. Techniques like this allow companies to quickly expand their prospect and customer database. Through consistent and repetitive messaging to this targeted, interested marketplace through a variety of e-alternatives, businesses can significantly increase revenues and bottom-line profits for literally pennies on the dollar that they have traditionally spent.

3.3 Customer Relationship Management

Relationship marketing is a strategy of building long-term partnerships with customers. Companies can build these partnerships by offering

value and providing customer satisfaction. The benefits to the company should include loyal customers and additional referrals, which ultimately lead to increased sales and profits. Additionally, marketing costs may fall because serving existing customers is less expensive than attracting new ones. Customer relationship management (CRM) is the process of identifying, attracting, differentiating, and retaining customers, which is the global approach the authors are taking to introduce CRM. However, when you look at this topic from an implementation standpoint, CRM is often broken down into a three-pronged approach; focusing on techniques and processes to improve customer service, using sales force automation tools to better connect and understand customers, and marketing automation.

3.3.1 Relationship capital

In an atmosphere where a seemingly endless number of businesses are vying for the consumer's attentions, customer loyalty may be more valuable than gold. A firm's ability to build and maintain relationships with customers, suppliers, and partners may be the difference between success and failure. It is this relationship capital that provides the springboard for future business. The central belief and benefit of relationship marketing is that if you take good care of your customers, they:

- Reward you with their loyalty (customer retention)
- Continue to purchase the current product or service
- Probably purchase any extended products or services (additional offerings from the same organization, whether related or unrelated)
- Refer you to their friends and business associates

3.3.2 Relationship strategies

Customer relationships can be practiced at three levels. At the lowest level companies build a financial bond with customers by using pricing strategies. The firm uses pricing incentives to encourage customers to continue doing business with it. Frequent buyer cards and frequent flyer programs are examples of level-one relationship building. This level of relationship marketing is popular with consumers, but it is the least effective strategy because it can be easily copied by other organizations, and it does not lead to a sustainable competitive advantage.

The second level of relationship marketing includes financial incentives, but also tries to create social bonds between the company and the customer. This may be the familiar birthday card from your dentist or hairdresser or the special service offered by your banker.

Level-two relationship marketing has greater potential for long-term advantage than does level one. This kind of relationship involves personal communication between the firm and the customer.

The third level of relationship marketing includes financial and social bonds, but adds structural bonds to the mix. Structural bonds are created by offering added-value that is delivered through structures that enhance the relationship. Federal Express offers software (not over the Web, but application software) to business customers so they can ship and track packages using their own computer. This creates a structural bond because customers come to rely on the convenience of this software and are less likely to switch to another shipper. All of the major Web portals are trying to create structural bonds with customers. For example My Yahoo! allows customers to tailor their interface to include things such as local weather, stock portfolios, and news items. Once consumers have invested the effort in customizing their interface, they are reluctant to start over with a different portal. In this case, the more My Yahoo's technologies become integrated into the day-to-day routines and actions of their customers (as it becomes their operating desktop), the more structural that relationship. The more structural the relationship, the stronger the bond between company and customer.

3.3.3 What is CRM?

Customer relationship management is an individualized marketing method that uses customer information to build long-term, personalized, and profitable relationships with each customer. The focus is on share of customer rather than on share of market. Whereas mass marketers develop a product and try to find customers to buy the product, CRM develops a customer and tries to find products for that customer. How can businesses really communicate with customers one at a time? The answer is in the use of database technology. The Internet is an effective tool for generating relationships with customers because it is a two-way medium that allows the company to interact with the customer.

3.3.4 CRM process

A marketing database is a tool that helps marketers reach customers and prospects with one-to-one communications. The information contained in marketing databases helps companies know and understand their customers. By analyzing the information, marketers can identify sales opportunities and drive the communications process to capitalize on them. The process involves gathering information about customers, differentiating between customers, and customizing effective marketing messages and mix for those customers.

3.3.4.1 Identify customers

Information is the essence of customer relationship management. Many firms gather information from a variety of sources such as at the time of purchase, from the sales force, and from Web activity, and use this as a basis of their marketing database. Another method of building a database is in the form of a response list. A response list includes the names and addresses of individuals who have responded to an offer of some kind, usually by e-mail or registering at a Web site for a contest, service, or special offer. A firm can gain customer and prospect information directly in the form of voluntary disclosure, or by tracking behavior on the Web, or a combination of both.

A quick way to begin building a marketing database is to purchase a compiled list. There are a great many compilations available, ranging from those owned by the large list brokers to small groups or associations willing to sell their membership list.

3.3.4.2 Differentiating customers

It is often useful to enhance the database beyond the customer's name and e-mail address. Companies can learn more about prospects or customers by including demographic, lifestyle, and behavioral data in the database. Customer profiles allow marketers to differentiate customers by more than product purchases. For example, it might be useful to know which customers had purchased mountain bikes in the last year through past sales data. However, if you also knew those customers' income, interests, and shopping habits, you would have a better understanding of the customer.

Firms often distinguish customers by how valuable they are. Some customers purchase more often, spend more money, and are more loyal than others. By learning about the best and most profitable customers, firms can understand how to maximize marketing communications and cross-selling opportunities as well as provide service to the very best customers. Further, by understanding the profiles of the best customers, companies can look for prospects that match the profile and increase the likelihood of creating more good customers. There is a belief in marketing that most organizations focus way too much energy finding new customers, when often their current customers are being underserved. Therefore, the most often overlooked optimum strategy is to better serve (sell more of the same, complimentary, or new products or services) the customers you have, than those you don't. For many businesses, even new customers are more of a byproduct of referrals rather than pure marketing persuasion anyway.

An important tool used to identify the firm's most valuable customers is called recency-frequency-monetary analysis (RFM). Research has shown that customers who purchased recently, often, and spent a certain

amount of money are most likely to purchase again. Using this data, the company can build a simple equation to identify the "best customers" and assign a score to each name in the database. Customers can be ranked by this RFM score and marketing communications can be tailored accordingly. Some firms take RFM analysis a step further by considering profitability in the equation. For example, a customer who has spent a large amount of money may fail to make it to the top of the list if all his or her purchases were sale items. If a frequent flyer travels extensively but only buys heavily discounted tickets, he or she was probably not as valuable as a business traveler spending the same amount of money but buying expensive last-minute tickets. Some customers buy a lot of merchandise, but make frequent returns. It may cost more to service this kind of customer and make them less profitable.

Another way to analyze customer data is to do lifetime value analysis (LTV). RFM information can be used to create a lifetime value model for customers. Whereas RFM considers how valuable a customer is in the short-term to the company, LTV projects the customer's value into future years. One of the assumptions underlying LTV calculations is that it is less expensive to market to a repeat customer than to new customers. It costs more to identify new customers and gain their trust than it does to retain loyal customers.

Customer lifetime value can be used in a number of ways. It can be used to determine how much it costs to obtain a new customer. It can be used to calculate the level of spending that is profitable to retain a customer. It can also be used to create a profile of what the most valuable customers are like and this can be used to target similar individuals that are likely to become valuable customers. Most importantly, lifetime value analysis enables companies to identify its most valuable customers and profit from them by building long-term relationships.

3.3.4.3 Customizing the marketing mix

The purpose of identifying and differentiating customers according to demographics (for example, age, gender, income, and ethnicity), psychographics (for example, personality, motives, values, and lifestyles), behavior (such as buying frequency, where you shop), or value (that is, RFM, LTV) is so the company can create a customized offering to groups or individuals. One advantage of customization is the ability to deliver personalized promotional messages to each customer. For example, Amazon.com creates a personalized experience each time the same customer visits its Web site. Customers are greeted by name and provided with a customized Web page offering book, music, and video suggestions based on the customer's past purchases and viewing behavior. Customization can apply to the entire marketing mix, not just promotion. Dynamic pricing can be used to tailor prices to specific

users. For example, Federal Express maintains millions of prices for various business users based on shipping volume. Distribution decisions can be customized to the user's preferences. For example, some customers may prefer to order online and then pick the product up at a local brick and mortar outlet. Others may opt for a specific type of shipping. Finally, product offerings can be customized to suit the user's requirements. Interaction between the company and customers is what makes CRM and customization work. Both the organization and the customer learn from the interaction, and in an ideal situation, both benefit from the relationship.

3.3.5 Implementation issues for CRM

CRM has many benefits and can be cost-effective. This is true because it is more far profitable to retain customers and extend additional products and services to them than it is to attract new ones. Or, it is less expensive to sell multiple products to one customer than to sell the same number of products to multiple customers. CRM can also create positive word of mouth about a company, product, or Web site. This happens when happy customers tell their friends and family about the positive experiences with a company. Word of mouth can be especially powerful on the Internet because a user can send information to a hundred friends almost as easily as they can to one friend.

With all these benefits, one has to ask why not all businesses are using CRM. One reason may be that CRM systems have a high failure rate. Recent studies indicate that CRM systems have nearly a 70 percent failure rate. (Jim Ericson, August, 2001) This statistic is mostly attributable to flawed implementation. Sometimes companies lose sight of the big picture when installing CRM software. A CRM package does not automatically improve customer loyalty and increase sales per customer. Companies must be willing to honestly evaluate the customer experience with the company and solve problems if they exist. A CRM system cannot solve a basic failure of the company in the customers' eyes. Another common reason for CRM installations failure is the lack of executive sponsor. Because CRM is demanding and expensive to install, it challenges the company to a great extent. Without an executive sponsor, a project of this magnitude is destined to struggle and may lose direction. Lack of integration is another serious problem. A CRM strategy cannot succeed without integration. Integrating CRM with other internal systems is difficult but necessary to give the customer a seamless experience. A lack of integration may make it impossible to create customer profiles that include shipping preferences and spending habits. The result may be a system with many manual steps across

multiple departments which can result in duplicate data entry, wasted effort, and data errors.

3.3.6 Privacy

Customer relationship management is intended to establish and maintain long-term relationships between the firm and its best customers. A customer relationship system requires a database with individual profiles that contain large amounts of personal data on each customer. The existence of these extensive databases leads to questions of trust and privacy. Can consumers trust the company to manage their personal information in an ethical manner while guarding their privacy? Do consumers really care about the privacy of their personal information?

Public opinion polls consistently find strong support among Americans for privacy rights and laws to protect their personal information from government and commercial entities. The Pew Internet & American Life Project surveyed 2,117 Americans about trust and privacy online. They found that American Internet users overwhelmingly want the presumption of privacy when they go online. The vast majority of American Internet users think it is an invasion of their privacy for businesses to monitor users' Web browsing. By a two-to-one margin they reject the argument made by some businesses that Web tracking can be helpful.

Consumers want companies to get their permission before using their personal information. Eighty-six percent of Internet users are in favor of "opt-in" privacy policies that require Internet companies to ask people for permission to use their personal information. A March 2000 BusinessWeek/Harris Poll went even further, showing 86 percent of users want a Web site to obtain "opt-in" consent before collecting users' names, address, phone number, or financial information. The same poll shows that 88 percent of users support opt-in as the standard before a Web site shares personal information with others.

About one quarter of those surveyed would not offer personal information to a Web site under any circumstances, while nearly two thirds of those surveyed would be willing to provide it under the right circumstances.

More than 90 percent of Internet users want privacy violators to be disciplined for misuse of information. "If an Internet company violated its stated privacy policy and used personal information in ways that it said it wouldn't, 11% of Internet users say the company's owners should be sent to prison; 27% say the owners should be fined; 26% say the site should be shut down; 30% say the site should be placed on a list of fraudulent Web sites." (Pew Internet and American Life)

There are several approaches to protection of consumer privacy. The first is legislative. The legislative perspective is based on the belief that companies cannot be trusted to safeguard the consumer information they gather and that state or federal laws are needed to protect consumers. The current government position is to create public-private partnerships to develop safeguards in this arena, according to a February 2003 White House document titled The National Strategy to Secure Cyberspace. However, protecting privacy, and many of its related areas such as antispam rules, identity theft initiatives, fraud and more, continues to accelerate as a critical issue as we continue to evolve into a digital society with information about everything we do stored electronically somewhere. With the Federal Trade Commission (FTC) receiving more than 10,000 consumer complaints about fraudulent and deceptive business practices each week, and with it receiving more than 100,000 consumer complaints about identity theft since 1998, and with greater enforcement of the Gramm-Leach-Bliley Act (from remarks of FTC Chairman Timothy J. Muris at the Privacy 2001 Conference, Cleveland, Ohio, October 4, 2001), you can bet that this area will receive more legislative attention in the future. Therefore, it is always important when taking on an e-business project to take time to understand what is occurring on the legislative front that would affect the implementation decisions you make.

The second approach to the protection of consumer privacy, in contrast, is the self-regulatory approach that the Internet industry has proposed. The most prevalent areas for self-regulation are privacy policies and seal-of-approval programs.

Many companies state their privacy policy online. A good privacy policy should include the following principles developed by the FTC.

1. Data collectors must disclose information practices before collecting personal information.
2. Individuals must be given a choice about whether and how personal information collected from them may be used other than the original purpose.
3. Consumers must be able to access and contest the accuracy and completeness of data collected about them.
4. Data collectors must take reasonable steps to safeguard information gathered from consumers from unauthorized use. They must also take reasonable measures to assure that the information collected from consumers is accurate.

Even the best privacy policy provides limited protection for the consumer because it is not a contract. Most companies reserve the right to change its policy without prior notice to the consumer. Further,

many privacy policies are written in dense legal jargon that may not be understood by the customer.

Seal-of-approval programs are another approach advocated to build the trust of the Internet public. To help businesses assure visitors that their sites follow certain guidelines, several certification authorities have sprung up. These are third-party programs in which member companies agree to be audited on their privacy practices, business processes, security, and other areas to assure the customer that "what the company says" is "what the company does." Only organizations that meet the requirements may exhibit the seal on their Web sites. TRUSTe, the Better Business Bureau OnLine, and the AICPA's WebTrust are examples of programs that businesses can join if they pay a fee and meet certain procedural guidelines.

Although TRUSTe and BBB OnLine are far more prevalent, the AICPA's WebTrust program is the most comprehensive and offers an assurance service in the true sense of the word. Each candidate is periodically audited according to the WebTrust principles and criteria, and the Web site must disclose a number of policies to be in compliance. This kind of work is not that different from that discussed in this chapter, except the work encompasses a smaller subset of tasks than an entire e-business effort. The CPA has the ideal skills for taking on this type of project as it is all about processes and compliance with them. The difference here is that you are not having to create and automate those processes, but rather verify that they exist and that they are being followed as the company prescribes. Even though the WebTrust seals have been slower to be supported than expected, the WebTrust review process has a significantly wider use. Many executives choose to go through the WebTrust process to ensure they are living up to their public promises. To learn more about this quickly growing area, either visit www.aicpa.org/Webtrust/index.htm or www.cpaWebtrust.org.

The weakness of this approach is that only a limited number of companies choose to participate in this strictly voluntary process. More information about any of these certifications can be found at TRUSTe (http://www.truste.org), BBB OnLine (http://www.bbbonline.org), and the AICPA (http://www.aicpa.org).

3.3.6.1 Privacy standards

One of the World Wide Web Consortium's initiatives, Platform for Privacy Preferences (PPP), is on the subject of privacy. This initiative tries to automate the communication between a Web site and a user in relation to privacy. It involves the following steps:

- A user's personal information is stored in his or her browser (for example, Internet Explorer) in a standard format.

- Web site privacy policies are translated into a standard format by answering a series of questions.
- Users set their preferences in their browser.
- The privacy policy data is placed in a specific file at the Web site and the user's browser automatically downloads the privacy policy when the site is accessed.
- The privacy policy is then compared to the user's preferences and the site automatically decides whether to transfer information or not, and to show a warning before the transfer.

There are a number of criticisms of this approach. Some critics believe that PPP is designed to facilitate the transfer of data to Web sites rather than protect individual privacy. It is very one-sided information exchange. There are detailed data elements relating to the user and no data elements relating to the requestor. There is also nothing in PPP that enforces or even assists in the enforcement of the agreements that are struck through its algorithms. In this sense, PPP facilitates the technical while ignoring the larger issues.

Many Americans believe the current self-regulatory framework is insufficient to protect privacy. A February 2002 Harris Poll showed that 63 percent of respondents thought current law inadequate to protect privacy. A June 2001 Gallup poll indicated that two-thirds of respondents favored new federal legislation to protect privacy online. A July 2001 Markle Foundation study concluded that 64 percent favored rules to protect consumers on the Internet, and 58 percent reported that self-regulation wasn't enough to ensure adequate accountability. A March 2000 BusinessWeek/Harris Poll found that 57 percent of respondents favored laws that would regulate how personal information is used. In that same poll, only 15 percent supported self-regulation. Companies must become more aware of consumer concerns about privacy—and act in an ethical manner to earn their trust. CRM is based on that trust, and customers must believe that the information they share be used in a responsible manner. Companies must carefully craft their marketing programs to ensure the privacy of the customers while still meeting the company's objectives.

4. WEB PRESENCE IMPLEMENTATION ISSUES

Thus far, we have created an e-business team, done the internal review and work necessary to understand the team's objectives and gaps that need to be filled, and done an external review of how we might want

to communicate to our marketplace. Now is the time to look at some implementation issues to create the desired Web presence. In this chapter, we have only two sections: Web site trends and Web site security. However, look at the appendixes to fill the implementation gaps:

Appendix 1: Web Site Features, Tips, and Tricks Checklist
Appendix 2: Terminology You Are Likely to Encounter
Appendix 3: Five Steps in the Web Site Development Process
Appendix 4: Web Site Costs
Appendix 5: Tips for Selecting Web Hosts and Web Designers

4.1 Web Site Trends

Internet usage is growing every day, if media reports are to be believed. Nearly 123 million people had accessed the Internet, according to Nielsen's NetRatings (as of February 2000). The worldwide estimate of the number online as of September 2002 is 605.60 million (www.nua.-com/surveys/how_many_online/index.html).

The users are distributed throughout the world as follows:

World total	605.60 million
Africa	6.31 million
Asia/Pacific	187.24 million
Europe	190.91 million
Middle East	5.12 million
Canada and USA	182.67 million
Latin America	33.35 million

The average household logs on 18 times and visits 10 sites a month. How long does the average user take to view one Web page? Customers may pause an average of 53 seconds on a page before leaving. Some of the emerging demographic trends include:

- The increase and eventual majority of women as a Web audience
- The increase and eventual majority of non-English-speaking Web visitors
- The increase in new beginner-level Web visitors
- The increase in average age of people getting online

If an organization wishes to do business with any of these groups, its site design should reflect the tastes and needs of the particular audience. For example, to attract a beginner, the site should be very clean, intuitive, and navigable, and offer lots of help, terminology definitions, and education in general.

Another trend is that both small and large businesses have sprinted out of the Web starting gate faster than medium-sized businesses. Large businesses have the financial resources to develop e-business capabilities quickly, and small businesses have the decision-making abilities to commit to an e-business strategy as part of their overall business plan. Caught in the middle are medium-sized businesses; some that have waited have to catch up in the e-business arena if they want to remain competitive long-term. Follow the trends at sites such as www.idc.com, www.nielsen-netratings.com, www.nua.com/surveys/how_many_online/index.html and www.computereconomics.com.

4.2 Web Site Security

Web site security is a topic often discussed and cussed by both users and businesses alike. Customers submit information via the Web only if they are confident that their personal information, such as credit card numbers, financial data, or medical history, is secure. One of the key characteristics of an effective Web site is easy and quick access of the Web pages by anyone from the Internet (public network). It is this very same access that makes Web sites vulnerable. Web sites have five main vulnerabilities:

1. *Web defacement.* Here attackers take advantage of weaknesses that allow them override the existing Web page(s) with their own. This could be done either by directly changing the code on the existing Web page or copying an unauthorized Web page with the same name as the existing Web page (thus replacing it). For example, a hacker uploads the unauthorized Web page exploiting File Transfer Protocol (FTP) weaknesses, such as guest account with full access (read, write, and delete) that does not require a password.
2. *Denial of service.* One of the most common attacks, the hacker sends an extremely high volume of requests to the Web site, thus overflowing the buffer and crashing the server.
3. *Unauthorized disclosure.* Here the attacker is able to gain access to sensitive information (such as Social Security number and credit card information) through unauthorized means. This would be possible by either modifying the Web page to provide the hacker with the information or by breaking into the database server containing the information.
4. *Spoofing.* The low cost of Web site creation and ease of copying existing pages makes it all too easy to create illegitimate sites that appear to be published by established organizations. In fact, con artists have illegally obtained credit card numbers by setting up professional-looking storefronts that mimic legitimate businesses.

5. *Date alteration.* The content of a transaction in transit is intercepted and altered either maliciously or accidentally. Data sent in clear text is vulnerable to such alteration.

On one hand, the more secure a site is, the more effort the users have to go through to use and navigate the site. A site that is too restrictive or difficult to navigate drives users away; a site that is too "loose" may incur liability or a bad reputation among users. The trick is for the business to use a security model that provides an adequate level of security without being too burdensome to the user. Three common security models include username-password (aka challenge-response), secure server (aka https), software certificates, and physical devices. Many Web sites today incorporate more than one of the standard approaches to construct an overall security model for a Web site. For example, a user may have to enter their username and password to enter an area of the site. Once authenticated, the site may pass the user over to a secure server for the execution of a financial transaction. Web site security is an extension of normal computer security since the Web site is customer facing whereas many other internal applications are not. Studies have shown that lack of proper security is the greatest deterrent to more people using e-commerce. However, there is probably more likelihood of a waiter at a restaurant capturing a person's credit card information and even signature facsimile than there is risk of loss over the Web if the proper security models are put in place. The challenge is to match the proper security level with the activities desired by the user of the site. For instance, the following layered model is commonly used when planning security for a Web site:

- Authentication (only if its conducing transactions)
- Safe passage (as Internet is a public domain, any sensitive or private information should be encrypted)
- Protection of physical servers (both from external and internal sources)
- Protection of html files/folders from write/delete access

4.2.1 Username-password (aka challenge-response)

As the name implies, users are prompted to enter a username and password as they enter a site or a section of the site. One of the most common security models, it is also the most prone to be compromised. As such, typical businesses tend to protect content or member-only information (as opposed to executing e-commerce transactions) through the use of username-password. Of course, the Web design process for this approach has its problems. First, there must be a way

to ensure that the chosen username is unique among the user population (that is, it has not previously been chosen by someone else). This is not always easy to do and can be a source of frustration to users who are looking for a common name that they can use everywhere (for example, unique usernames that are easy to remember on AOL's Instant Messenger are scarce). Once the chore of picking a unique username is out of the way, the site must then ask the user to select a password that they can remember (hopefully without writing it down). While this is not difficult (since there is no requirement for the user to pick a unique password from others), users may often misspell the password they intend. Thus, most sites ask users to rekey the password just to make sure they have entered it properly. Of course, if greater security is required, a specific password construction may be demanded (for example, the password must be a minimum of eight positions and contain at least one capital letter and one number). Many businesses tend to shy away from such restrictions unless they are handling financial data because it tends to be frustrating to users. It is very common for Internet banking sites (including many national banks) to use the Social Security number of the customer and a four-digit password for customers to access their financial information. In many cases, the customers are not required to change their passwords at all.

Some sites may choose to rely on a username-password model but desire even more security. Typically the best way to accomplish this is to ask rotating questions about personal information the user supplied in his or her profile. For example, one time the site may request the last four digits of a user's Social Security number and the next time the site may ask for the year the user was born. All of this is in addition to the standard username-password.

4.2.2 Secure server

Once a business starts to embark on executing e-commerce transactions, the ante on security is elevated. Often a secure server is used whereby communications from the user to and from the server are encrypted. Encryption makes it almost impossible for someone who might be able to intercept the transmission to decrypt the communication. When executing banking transactions, both a secure server with at least 128-bit encryption (aka know as "strong encryption") is de rigour (browsers often start at 64-bit encryption level and this is one case where users must enhance their browser to effectuate banking transactions). Standard businesses with e-commerce sites should at least use a secured server model, although they may not choose to elevate the encryption to the more secure 128-bit level. Users can verify that the site is encrypting communicated data by the presence of a padlock or unbroken key in the browser window.

Because a browser typically expects to operate without talking to a secure server, most businesses first ask the user to authenticate by means of a username-password and, once authenticated, are then automatically redirected to a secure server site.

4.2.3 Software certificates

Another form of authentication is to use a physical certificate that is issued by the business (or trusted certificate authority or CA) that identifies the user (or even a server). Users must then accept the certificate and install it in their browser. Once installed many certificates (not all though—there are different levels of certificates that can be issued) can be used to digitally "sign" transmissions indicating that the user is indeed the originator of the communication. These same certificates can also be used to encrypt communications (similar to a secure server) and only those who have been given the "key" in advance can decrypt the transmission.

Installing the certificate can be baffling to many users. Once installed, however, certificates are easy to use. In the future, there will be a heavier degree of reliance upon software certificates as a means for authentication and as a basis for security. Even the American Bar Association has issued guidelines regarding the positive enforceability of transactions that use a certificate-based model for security and authentication.

A "cookie," or token of information that is stored on a user's machine, is *not* considered to be a good form of security because cookies are often fragile and can easily be deleted. They can be, however, a shortcut to storing information that the user does not want to have to continually re-key. Once again, there is a delicate trade-off between "ease of use" and security. Today, many users opt for "ease of use," although with the growing volume of users and financial transactions, users begin to have to weather a more secure and less "friendly" site in the future to conduct business over the Web.

4.2.4 Physical devices

Physical devices are akin to software certificates in that they are a tangible piece of information that must be present at the time of authentication. Like software certificates, hardware devices must be ported from place to place and controlled. An example of a physical device used for security would be the American Express Blue Card, which contains a chip inside the card that can be used to authenticate a transaction. Smart cards such as these are gaining popularity overseas but have yet to be used widely in the United States because of the necessity to carry the physical device to effectuate a transaction.

5. BENEFITS OF AN E-BUSINESS INITIATIVE AND A WEB PRESENCE

Many businesses benefit tremendously from having a Web presence. Some companies, such as Amazon.com and ebay.com exist solely on the Web and have no "brick and mortar" presence. As stated earlier, the most successful approach is to "e-ify" an existing successful business to provide it with another effective marketing and distribution channel. Some of the most common benefits are:

- A global reach. You can offer, sell, and support your products and services almost anywhere at anytime. Small businesses are not geographically to a mile radius. In addition, if the Web site is translated into languages other than English, the company's offerings reach even more people, because research shows that non-English speaking visitors will represent the eventual majority of Web users.
- A low-cost marketing channel. A Web site can provide significant marketing advantages, as we have discussed throughout this document. Most businesses, especially small ones, have the same big weakness—good products or services that no one knows about. A well-thought-out Web presence can help attract and retain business using a variety of low-cost strategies (such as e-mail, newsletters, coupons).
- A tech-savvy presence. A Web site enables an organization to illustrate to clients and prospective clients that it is up-to-date with technology trends and committed to changing and growing with the times.
- Customer self-service. Knowing the most common frequently asked customer questions (FAQs), or problems customers encounter when using your offerings, is a great first step to leveraging the Web's self-service capability. The greater the knowledge base you put together on the Web, the more clients can help themselves, the less personnel it takes to support your offerings, and greater the level of satisfaction customers' experience. There is nothing worse than a customer purchasing a product over the weekend who then has a typical problem setting it up, and no place to go to ask questions. A good Web site is the solution. If your self-service help desk is successful, you might find staffing it full-time with chat capability and quick turn-around e-mails might be the logical low cost next step to offload your current phone support costs.
- 24/7/365. The company can maintain a presence with clients and prospective clients 24 hours a day, 7 days a week, 365 days a year.
- A platform for future technological advances. By taking the first step in creating a Web site, you are building a foundation for further,

phased technological growth. As the organization grows and changes, it can layer new technologies on top of the initial platform. The first site can be developed quickly and improved on as the business's Web knowledge and expertise grows.

- An opportunity to educate customers about the best way to do business with you.
- An opportunity to provide additional customer value through articles, newsletters, tips, and other actionable Web-based content.
- An opportunity to deliver services digitally. There is a tremendous amount of time and money spent communicating and distributing information with customers, employees, investors, etc. By having this kind of information on your company intranet or on the Web site, such information as company documentation, press releases, product manuals, and internal process forms are easily, instantly, and inexpensively distributed just in time for those who need or want the information.

There are many good reasons to "e-ify" your business, and we have just scratched the surface with what we covered in this document. However, the best reasons the authors can think of is that ignoring the electronic side of doing business would be like trying to swim with one hand tied behind your back. Although it is certainly possible to do this, it takes significant effort to make incremental progress and it is easy for others to outpace you. E-business is just one of the ways we do business today. It allows you to reach out to those you serve 24 hours a day, 7 days a week, 365 days a year, without the cost burden traditionally required to do this. The marketplace is moving in this direction. Therefore, either your competitors already have, or will soon be, creating e-business initiatives of their own. Five years ago, "e-ifying" your business was a luxury. Five years from now, it will be standard operating procedure. The bad news is that implementing something this complex is not a yes or no issue. It is too big a leap for most companies to holistically do successfully in one iteration. It is an evolution. So, the sooner you get started, the sooner this important evolution can begin.

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APPENDIX 1: Web Site Features, Tips and Tricks Checklist

Some of the features, tips, and tricks to creating a quality Web site include presenting or considering the following:

- Company information
  Name, logo, contact information, address, map, directions, phone, and e-mail address. Many sites neglect to include important phone numbers.
- Employee directory
  Names, biographical information, photos, service or product affiliations, phone numbers, and e-mail addresses. Some organizations do not post employee names for fear of headhunters.
- Products and services
  Catalog, prices, photos, descriptions, characteristics, and delivery information.
- Advice, in the form of articles, newsletters, tips, checklists, interviews, forms, white papers, presentations, and case studies
- Links to other sites
- Customer testimonials
  Customer testimonials, referral letters, or other positive feedback can be collected over time. Placed together in a notebook, file, or inbox, they can be periodically added to a special section on the site.
- Important information and policies
  Legal information and policies, such as privacy policy, security policy, return policy, copyright, and usage disclaimer.
- Audio and video information
  The Web is multimedia capable and willing, so companies that make good use of it stand out. Show your product in use, or someone discussing how your service is delivered. However, don't put out video, audio, or animation just to be cute—your serious visitors likely feel like you wasted their time.
- A site search engine
  If the site is over 20 pages, add a search feature that helps surfers find what they are looking for easily.
- A feedback page
  This can include e-mail or bulletin board areas.
- An e-mail subscription page to "opt-in" for news information, a newsletter, product updates, and other items, to capture visitors e-mail addresses
  The organization should have some form of regular (once a month, quarterly, annual) communication with those who sign up, which can

something as simple as mentioning one or two quick tips or news items, or it can be as expansive as a full-blown regular newsletter.

- Customer service features, such as a hot line, order tracking, or account maintenance
- Private sections for existing customers
  This typically involves limiting certain areas of the site to specific customers.
- A set of tools, such as a loan calculator, tax calculator, or budget tool
  The tools you offer should make sense to the audience you are attracting. If you are a travel site, offer some kind of travel planning tool or easy access to signing up for a variety of frequent traveler programs. Be creative. This type of application keeps the site interactive and offers visitors a reason to come back.
- Personalization and customization for visitors
  A site is personalized when each user views a different home page than the next visitor. Examples of this can be seen at My Yahoo! or Amazon.com. Personalization can be used very effectively to provide the user with the exact information he or she has requested and can be used to increase sales. For example, once a visitor has purchased a few things, Amazon.com uses a combination of data mining and personalization to suggest products that would likely be of interest based on those purchases.
- A discussion group
  If this application is being considered, first find out the likelihood of audience participation, to judge whether it be worthwhile to pursue. Content must constantly be monitored, and the board must be constantly "fed" with the company's staff comments and e-mails to people inviting them to contribute. A business considering the addition of a discussion group application should also include a copyright notice where applicable and legal disclaimers that the content posted may not necessarily reflect the company's views.
- New, actionable content
  Keep the Web site information fresh, updated, and loaded with "news they can use." Sites announcing events that have already occurred and those that haven't changed in a year promote the idea that the organization is sloppy or unprofessional, which likely affects customer perception negatively.
- Relevant links
  Visitors want an easy way to get more information about some of the topics you cover and the products and services you have. Create links to a strategic partner's site so the customer can gain a more detailed

understanding about some aspect of using your offerings. A link to a manufacturer of a component, or contractor to install it, or a warranty company to extend its life, for example, might be all the logical relevant links your site should offer.

- Navigable
The three-click rule means the average visitors should be able to find what they want in three clicks or less. This is a critical component of your design consideration. The potential customer loses patience with your site very quickly, and therefore moves on, if your user interface is not simple, easy, and intuitive to use.

- Answer the e-mail
When the site provides e-mail links, testing can make sure the links work, but your processes need to ensure that someone timely answers them. If a visitor requests information and doesn't have a reply within 24 to 48 hours, they likely move on to their next alternative. If replies, because of a company's current situation (such as during extended holiday, incredibly busy seasons, or current project backlog) are going to take longer than 24 to 48 hours, post notice on the site so expectations are set correctly.

- Pages download quickly
Know your customers. If many of them visit your site with slow bandwidths, such as 56k modems, then keep your site graphically simple so the pages load fast. If your audience predominately comes to you via DSL, cable, or other high-bandwidth alternatives, then your flexibility with heavy graphics and video are much greater. You don't want to frustrate your audience by having them constantly wait as the various Web pages load. Also, as a side note, when you offer file download capability, let your customers know, based on various bandwidths, how long a process is likely to take so they can plan accordingly.

- Coupons and incentives
Some users are attracted to discounts. If this vehicle works as a means for you to quickly build your customer database, get creative. As we discussed earlier, coupons and incentives can be very beneficial if done in a way that makes sense to your audience.

APPENDIX 2: Terminology You Are Likely to Encounter

As with any technical area, technology has developed its own vocabulary. Here are some terms and acronyms you are likely to encounter when having discussions about better use of the Internet:

ASP. This acronym has a double meaning. In the context of Web pages, it stands for a Microsoft technology, active server pages. At the end of the Web page address, a user may see a file name that ends in .asp. This type of file exists dynamically and is generated from a combination of Microsoft technologies. The acronym, however, could also stand for application service provider, which is a company that offers or outsources the use of software packages through the Internet.

AVI (audio video interleaved). This is a standard format for digital video.

BPS (bits per second). This is the measurement of the speed of data transfer in a communications system.

Browser. A browser is a class of software that interprets Web languages and displays Web pages. The two most prominent Web browsers are Microsoft's Internet Explorer and Netscape's Communicator.

C++ This is a fast, powerful programming language.

CGI (common gateway interface). When a user completes a form with information, there must be a way to send it from the browser form to the server, and CGI acts as a standard to define this transfer of information.

Domain. Domain refers to a portion of a Web site address, such as aicpa.org.

DNS (domain name server). DNS is a numerical address of a Web site consisting of four sets of numbers, such as http://209.111.241.38.

FTP (file transfer protocol). FTP is a protocol for transporting files from one server to another. It is also a program that does the same thing. A user needs FTP to update its small Web site so the files on its local computer can be transferred to its Web server.

GIF (graphics interchange format). A type of graphics file that is small and suitable for the Internet. It is not high enough in quality to be used in print media.

HTML (Hypertext markup language). This is a tag-based programming language for Web pages. A browser is the software that interprets the HTML and turns it into the Web pages that a user see.

HTTP (Hypertext transport protocol). This communications protocol enables the Web and allows the display of Web pages.

Java. This Internet programming language is independent of hardware platform.

JavaScript. A scripting language used in Web sites, JavaScript differs from the Java language above.

JPEG (Joint Photographers Expert Group). This type of graphics file is higher in quality than GIF and is suited for the Web.
KPS (kilobits per second). This stands for one thousand bits per second.
MBPS (megabits per second). This stands for one million bits per second.
MPEG (Motion pictures expert group). It is a standard for the compression of moving images.
PDF (portable document format). A type of file created by Adobe Acrobat Reader, this is a common way to make graphical or forms-based documents available to Web surfers without giving them editing control over the document.
POP (post office protocol). This refers to a type of Internet e-mail account.
TCP/IP (transmission control protocol/Internet protocol). This is the primary network protocol of the Internet and of intranets.
URL (uniform resource locator). The address of the Web site, such as http://www.aicpa.org, is its URL.
VBScript. This scripting language is used in Web sites.
WAV. As a file format for audio signals, WAV is generally also the file extension for audio files.

APPENDIX 3: Five Steps in the Web Site Development Process

Developing a Web site is a special type of systems project, but some of the traditional systems development techniques are appropriate here. One approach is to use a traditional systems development methodology that incorporates phases such as feasibility, requirements analysis, design, programming (buy or build), testing, implementation, and maintenance. Presented below are some major parts of this process.

Step One: Domain Registration

A domain name is the extension (for example, .com, .org, .net, .tv, .name) address of the site. It is also part of the uniform resource locator (URL). An example of a domain name is aicpa.org, while the full URL is http://www.aicpa.org. A user types in the URL in the browser window to travel directly to the home page of the site.

For this to work, all domain names must be registered so they can be attached to their physical servers, or the machine that contains the Web page files. This is done by means of a directory structure, and a variety of companies (Network Solutions, Register) can handle the domain registration process. Once an organization or user has determined the domain name it wants, and has found that it is available, it can register the name in two ways. If it already has a Web host selected, it should go through its Web host to register the name to simplify the process. If the company does not have a Web host, and therefore does not have the physical Web server information yet, the domain name can be registered directly with, for example, a provider like Register.com.

Naming the site is crucial. Most of the acronyms are gone (two, three or four letters representing the first letter of each word that is in the name of your business). The trend over the past few years was to use as few of letters or numbers as possible in the naming of your site. As the letter combinations began to disappear, professionalizing the name became popular. For example, if your CPA firm was Jones, Jones and Jones CPAs, there is a strong likelihood that jjj.com would be taken, but that jjjcpa.com was probably available. However, the trend today is to simplify. If you are Disney, then reserve the name Disney.com. If you are John Smith, CPA, then reserve johnsmith.com. You want to make it easy for someone to find you. And naturally, today, their first guess is going to be to type the name of your company and add ".com." Additionally, new extensions continue to be released to open up more naming options. For example, .com, .net and .org have been around for a long time, but extensions like .tv, .biz, .info are newer extensions,

with more being released as the need arises. There has been work done, for example, to create a professional extension, ".pro," for accountants, lawyers, and others who have supporting licensing organizations monitoring them.

Another trend is reserve several versions of your name if you can, including the most common misspellings. For example if your site name was bobbybraun.com, you might also reserve bobbybraun.net, bobbaun.com, and the most common likely misspelling—bobby brown.com. A Web host can point all of these domain names to the same site to ensure that the customer can easily find you. If a company hasn't reserved its name, it should do so immediately before a competitor or other party reserves it and all its likely extensions. This may be important because a site with your name and a different extension may become a public relations nightmare. Consider www.whitehouse.gov versus www.whitehouse.com. The first is a site that updates the public on news, policies, activities of the President and the White House. The second is an adult-oriented site. So, visit http://www.networksolutions.com or http://www.register.com, to reserve your names now.

Step Two: Functionality Development

Deciding exactly what the Web site should do and what should be presented is the most difficult task of the entire process. That is why we spent time early with our e-business team assessing the strategy. You want to have the commonly expected functionality, such as company and product and service information, directions to the office, a company phone directory, and a list of products on special for the month, but you also want the site to help you conduct your day-to-day business, for example, answer common questions, have a help desk, offer products for sale, and deliver shipping information. Your Web site is a 24/7/365 interface to your marketplace. Make sure you leverage your Web presence in such a way that many of your customers' common needs can be taken care of, and your company can reduce costs and/or increase revenue through this effort.

Besides moving as many business processes to the Web as possible, the next largest component is content development. Luckily, content is everywhere, and it should be recycled. Look in the company's business plan and other planning documents; marketing brochures and other support materials; and press releases, business cards, product catalogs, sales presentations, customer testimonials, and photos of the recent picnic or awards dinner. All these items tell the story of the business and can be transported, or "Web-ified," for use on the site.

Once these materials have been gathered, a list can be made of what will and won't be included. As has been the theme of this chapter,

the guiding focus should be the overall strategy and purpose of the site and how the company's inclusion of the information can add value. If the list is turned into a hierarchy chart, a site map is created. For example, the list might include a newsletter, a white paper, a contact page, a map, and the president's biography. A chart may start with the home page, which describes the company and products very generally. The home page might include a library section and a company section. The library contains the newsletter and white paper, and the company information section contains the contact information, the president's biography, and the site map.

Step Three: Presentation Design

What should the company's Web pages look like? A Web site should contain a combination of text and graphics, laid out in a professional-looking design. It can start with a graphic of the company logo and name. These should be prominent at the top of the page.

Site design should be visually appealing, intuitive in navigation, and reflective of the corporate culture or "look." If the organization is young, still developing, and energetic, the Web site should probably reflect this. There are plenty of multimedia tools to help create this kind of feel. A conservative culture might want to also reflect this using conservative colors and graphics. It's a good idea to have all of the company's public face (for example, marketing materials, letterhead, logo, and Web site) to have the same "look and feel," which is an important step if you want to create a brand image with your customers.

A few things to stay away from in Web site design include frames, too many graphics, and pop-up windows. Frames are maintenance-intensive, do not work the same in all browsers, and are generally frowned upon from a style standpoint. Both pop-up windows and heavy use of graphics, including too many swirling and flashing objects on one page, can be considered annoying by users because they usually do not add value to the content.

Web pages can be static or dynamic. In this context, dynamic is not meant as exciting, but refers to areas of sites in which the dynamic portion is assembled on the fly from underlying data sources. Web pages can also be coded from scratch with no automation or modularized into nonredundant components. The use of Web design programs and good basic systems design techniques keep the Web site from becoming a dinosaur or a maintenance nightmare. Everyday, more tools are made available to make what used to be extremely complex almost routine.

To get design ideas, go to any of the search engines and look at other sites in your industry. Consider what they are doing, but don't

stop there. Look outside your industry for the freshest ideas in Web design. One final suggestion on the design front is to find yourself a good Web design firm to assist you in all of this (unless you have your own design department). This step in the project takes a great deal of creativity. Even if you are good at this, recognize that sometimes you are so deep in the forest that you don't see the trees. An outside design perspective about what might be effective might be the best money you spend. You know what the business purpose is, and you need to make sure that is achieved. But you want to have people on this project that can let you know what the latest techniques, alternatives, and tools are to assist you. As well, you want some real creativity put behind the look and feel of your Web site. Remember, you are building a public brand image. If you haven't already done so, this is the time to make sure that you are putting a consistent and desirable "public face" on your organization. How you present yourself on the Web is a great starting point.

Step Four: Testing and Implementation

Once all the Web pages have been created on a new site, they should be tested. Links and buttons, for example, should be tested to make sure they work as anticipated. Consistency in look and feel (for example, font size, navigation bar placement, and color scheme) should be reviewed to make sure each page is displaying correctly. A copy editor should check for not only grammar errors and spelling mistakes, but also conciseness and clarity of the message. All the graphics should be checked to make sure they load correctly and quickly. Any graphics that are too large should be reworked in a graphics package to fit the site's requirements.

If any forms are used, a test should be done to make sure the user can easily navigate and edit the document, and upon submission, another test should determine that the data is captured correctly. If a database is being used, the records should be reviewed to make sure the data is being collected accurately.

Most important, test that the e-business functionality is properly passing the data between all the necessary applications and system.

Because there are too many of these testing cases to memorize or remember, a test plan is usually created. A test plan is a document used during testing that lists every item to be tested, assigns a tester, and contains a column to record the results of the test. Once a site is thoroughly tested, it can be moved (uploaded) from the production test site to a live site (accessible to the public). A retest should be conducted as soon as the files are installed to ensure the installation

worked correctly and that there are no environmental problems that were overlooked.

Step Five: Maintenance

Once the initial Web site is up and operational, it doesn't take long for it to become out of date. You need to constantly change it to reflect what is currently going on with your business right now, including changes to products and new services. The best approach to this conundrum is to set a maintenance schedule and delegate this responsibility to an employee. The employee should be constantly looking for changes he or she sees in the company's offerings or situation, such as the announcement of a new strategic alliance, training on how to use a specific functionality, another installment of a newsletter, an employee recently promoted who can be spotlighted, or a testimonial letter from a customer. The employee should be trained to update the site and work with the webmaster. Clearly, the employee should also be instructed on what kind of information is not suitable for publication on the Web site to avoid public relations disasters.

There can be more work than simply maintaining a site. If there are forms on the site such as a customer feedback form, this information must be evaluated by the right parties. If there is an e-mail sign-up function, an employee must manage the process. If the site captures orders, the orders must be processed. All these functions must be delegated to employees who have the skill sets and training to get the job done. The new jobs must be added to their existing accountabilities and be part of their performance review process.

APPENDIX 4: Web Site Costs

Not counting costs such as the integration work required to connect various systems to the Web site interface, or the indirect costs of the e-business team performing its evaluation and implementation, or the software required to handle the transaction once they have been processed by the Web interface, there are several other costs of developing a Web site. The most inexpensive is domain registration (unless you want to buy a name someone else is already using—then this can get quite expensive). Another is the hosting of the site, which consists of storage and file transfer costs. A third, which is by far the largest cost, is the cost of development and design, which includes the delivery of all of the functionality that the e-business team has defined (including design, navigation, and look and feel). Some specific cost components of implementing a Web site are described here.

Domain Registration

As discussed above, the company can register its name(s) directly with a registrar or through its Web host. The cost per name is usually around $35 for one year, but the price goes down quickly the more years you buy. The Web host may also charge a separate setup fee, or just roll the procurement of the name into its standard setup fee.

Hosting

Hundreds of excellent companies host Web sites for businesses. A vast majority of Fortune 500 companies do not attempt to host their own sites and instead use hosting companies. The complexity of hosting a site requires employees to become experts in network administration, performance loading and balancing, 24/7 support, information security, Web standards and domain updates, telecommunications, backup and disaster recovery, database management, program troubleshooting and debugging, help desk, and much more. Yet some businesses have tackled their own Web hosting at great financial expense and time. Unless a company is committed to this task full-time or has very unique requirements, it makes both financial and strategic sense to outsource Web hosting to someone who is focused and devoted to this line of business.

Web host companies offer a number of services that fall into two primary categories: virtual and dedicated. In a virtual setup, a company's Web site shares a machine with other companies. This is the least expensive solution and be the right one for the vast majority of small

businesses. Typically, this service costs from $25 to $75 per month, depending on storage and capability requirements. Included in the service can be e-mail post office protocol (POP) accounts; file transfer capabilities; Telnet or terminal access where batch jobs and other commands can be executed; secure server availability; forms, database, and programming processing; video and audio capability; a control panel with maintenance options; and much more. There may be extra charges and setup fees for some features. Companies expecting less than 10,000 hits per day (most receive several hundred or less) with Web sites containing less than a few hundred pages can select the less expensive virtual solution.

A dedicated solution earns a company its own Web server. This solution is appropriate for larger sites with a heavy amount of traffic. It is also correct for companies with unique processing, database requirements, or security issues. Dedicated servers can range almost anywhere in price, from a few hundred dollars a month, to hundreds of thousands of dollars a month, depending on the business's specific requirements.

Design Costs

The costs to design a Web site vary from site to site, because not all Web sites are the same size or offer the same functionality. Some general cost ranges of Web sites for initial design and implementation only, not including maintenance, depending on the size of the company, might be:

- Small business: $1,000–$10,000
- Medium-sized business: $10,000–$50,000
- Large company or special type of site, such as online banking: $1 million and up

The most common costs that get left out of Web site budgets include marketing, strategy, and maintenance. On the flip side, some costs are actually free. Beware of taking shortcuts, however. Remember that you want the site to appear inviting and reflect the company image and brand. On the other hand, a Web site is merely another vehicle for exposing your company to the marketplace. Balance the amount of money you are willing to invest in your Web presence with how you plan to use it, what your expectations are, how you expect your customers to use it, and your overall expected ROI.

Other Web Site Development Costs

Other costs to consider when developing a Web site include:

- Maintenance. Much of the maintenance cost is an indirect cost as people from your organization need to continually update information, respond to requests, and react to feedback. If you choose to redesign your Web site every year or so, you have to repeatedly pay fees similar to those described above. The authors believe your Web site should be a reflection of your branding and image, and therefore, constant complete redesigns are a reflection of poor marketing planning. However, new functionality should always be considered if it better promotes your products and services, assists customers, or improves the bottom line of your company's performance.
- Customization. Factor in costs to integrate the site's electronic commerce transactions with the back office.
- Hardware and software. These could include a graphics package, a Web development package, and servers if the company hosts its own site. If the company uses a hosting service, it still needs to buy software, such as Microsoft's Front Page, to update the site, graphics software to create or change images, video editing software if creating steaming video to be available on the Web, and the like.
- Training. Consider training costs for employees who are responsible for various Web duties. The tools in this technology area are constantly changing and improving, so training is an ongoing necessity if you want to get the most out of your Web presence investment.
- Help desk. Costs of support function for people who visit the Web site and need assistance. For many companies, they outsource this to their Web host, or other help-desk services.
- Marketing. The cost of implementing a complete online marketing plan and integrating Web marketing with the company's existing marketing plan needs to be budgeted.

APPENDIX 5: Tips for Selecting Web Hosts and Web Designers

Selecting a Web Host

Some of the criteria with which to judge a Web host include technical expertise, reliability, reputation, support, price, and experience. Some of the questions to ask a prospective vendor you are evaluating include:

- Is support available? If so, what are the hours?
- Are setup instructions clear and posted? Most sites are lax in offering clear setup rules, which means everyone must call the help line. As a test, call the help line and see how long it takes to get connected, and how well the questions are answered.
- How fast the Web host's site load? Ask the Web host to furnish the names of similar customer sites. Test how long it takes for these sites to load.
- What hardware platforms do they offer, and do they offer the services your business needs? This should include customer programming needs, file transfer availability, newsletter distribution capability, password protection for certain areas, multimedia capabilities, and whatever else your design calls for.
- Is the price within the budget? Are there setup fees? Monthly fees? Per megabyte fees?

Selecting a Web Designer

The other partner in Web development is the Web designer. In many cases, this and the Web host are the same company. Some Web designers also prefer to work with specific Web hosts and can shelter a client from the technical decisions of Web host selection. Some questions to ask potential Web designers are:

- Are they familiar with your industry? Ask them for Web sites they have created that are in the same industry or if not, perform similar functionality.
- Does their style fit your company? Even though some work for large companies, Web designers are individuals with individual tastes. Can the designer match the style your company needs to portray? The best way to answer this is to visit several sites they have designed.
- Do they offer the services and functionality that your need? You don't want the standard answer to be, "We can program that." You are looking for the comment, "Yes, we created a similar function for . . . ."

- Can they lead you through a systematic design process if you have any doubts about what you want or how you want it presented?
- Do they have artists on staff who can manipulate graphics or create them?
- Do they offer content creation or editing?
- If programming is necessary, what programming languages do they use? Does that fit with the company's standards and needs?
- Can they handle ongoing maintenance? Would they train one of your employee's to handle the routine maintenance tasks?
- Do they offer site marketing? Offline? Online? Exactly what do they do to market/promote the site?
- How do they price their services? Is the fee in line with your budget?

Social Security

SOCIAL SECURITY AND OTHER ISSUES FACING ELDERLY OR DISABLED CLIENTS

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SUGGESTED REFERENCES

APPENDIX 1: Sample Advance Directive (Living Will) (*see Toolkit CD-ROM*)

1. INTRODUCTION

In 2004, there were over 47 million workers receiving Social Security benefits, compared to approximately 25 million at the end of 1990 and approximately 19.5 million at the end of 1980. Senior citizens represent one of the fastest growing segments of the U.S. population. In addition, in 2003, over 6.8 million workers were receiving Social Security disability benefits.[1] This chapter presents an overview of the U.S. Social Security system and certain other issues of increasing relevance to the practitioner representing elderly or disabled clients.

2. SOCIAL SECURITY

2.1 Introduction

The Social Security Act, published as Chapter 7 of Title 42 of the United States Code, governs a wide variety of programs that presently cover nine out of ten workers in the United States. The administration of the Social Security Act is the responsibility of the Social Security Administration, an independent federal agency headquartered in Baltimore, Maryland, with approximately 1,300 local offices located throughout the United States, the U.S. Virgin Islands, Puerto Rico, Guam, and American Samoa. Information regarding the Social Security Administration can be obtained by calling (800) 772-1213 or by visiting the Social Security Administration's Web site at http://www.ssa.gov.

The Social Security Act provides for programs such as old age, survivors, and disability insurance benefits (commonly referred to as OASDI or Social Security benefits), Supplemental Security Income benefits, and Medicare benefits, each of which is discussed further below. While the future of the Social Security system remains the subject of great controversy and concern, Social Security provides the primary source of retirement and disability benefits for many Americans.

2.2 Funding

Social Security benefits are generally funded by the withholding of taxes from employees and contributions by employers pursuant to the Federal Insurance Contributions Act (FICA) and by the collection of self-employment taxes from self-employed individuals.

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[1]Source: Social Security Administration.

Out of every dollar that workers and their employers pay to Social Security taxes:

— Eighty-five cents goes to a trust fund that pays for monthly benefits to retirees and their families.

— Fifteen cents goes to a trust fund that pays benefits to people with disabilities and their families.

The entire amount of taxes collected for Medicare goes to a trust fund that pays for some of the costs of hospital and related care for all Medicare beneficiaries.

2.2.1 Employees

The FICA tax imposed on employees consists of the following two components:

— A tax of 6.20 percent of wages up to the "Social Security wage base" ($97,500 for 2007) which is used to fund OASDI benefits (retirement, survivor, and disability benefits)

— A tax of 1.45 percent of total wages which is used to fund Medicare hospital insurance benefits

FICA taxes are collected from the employee through withholding from the employee's paycheck. The employer also pays a tax equal to the total FICA tax collected from the employee.

> *Example.* For an employee earning $400,000 per year, total FICA taxes will be calculated as follows:

Employee Portion:		
6.20% × $ 97,500 =	$6,045.00	
1.45% × $400,000 =	$5,800.00	
Total		$11,845.00
Employer Portion:		$11,845.00
Total:		$23,690.00

2.2.2 Self-employed persons

Self-employed persons having "net earnings from self employment" in excess of $400 annually are subject to self-employment tax consisting of the following two components:

— A tax of 15.30 percent on net earnings from self-employment up to the Social Security wage base ($97,500 for 2007) to fund OASDI benefits

— A tax of 2.9 percent on total net earnings from self-employment to fund Medicare hospital insurance benefits

For purposes of calculating net earnings from self-employment, an individual is entitled to a deduction equal to the product of (a) net earnings from self-employment (computed without the deduction) up to the Social Security wage base, multiplied by (b) 50 percent of the total self-employment tax rate.

Example. For an individual having net earnings from self-employment of $53,000, the self-employment tax is calculated as follows:

Net Earnings:	$53,000.00
Less: $53,000 × 7.65%	($ 4,054.50)
	$48,945.50
Times: Total Tax Rate	× 15.3%
Self-Employment Tax	$ 7,488.66

Farm optional method. Taxpayers with gross self-employment earnings from farming of not more than $2,400 can elect to report as net earnings from self-employment two-thirds of gross earnings. If gross earnings exceed $2,400, the taxpayer may elect to report as net earnings from self-employment the greater of actual net earnings or $1,600. There is no limit on the number of times an eligible taxpayer may elect to use the farm optional method.

Nonfarm optional method. Self-employed taxpayers who are not engaged in farming may elect to compute net earnings from self-employment under the nonfarm optional method for any year if

— Actual earnings for the year are less than $1,600.

— Net earnings from nonfarm self-employment constitute less than two-thirds of the taxpayer's gross income from nonfarm self-employment for the year.

— The taxpayer had net earnings from self-employment of $400 or more in at least two of the three years immediately preceding the year in question.

If a taxpayer is eligible to elect the nonfarm optional method, he or she can elect to treat two-thirds of his or her gross nonfarm income (up to $1,600 per year) as his or her net earnings from self-employment for the year. The advantage of the election is that it allows taxpayers to pay into the Social Security system based on a higher earnings level (thereby potentially increasing benefits payable). A taxpayer may elect to use the nonfarm optional method no more than five times.

Example. Farley, who is otherwise eligible to elect the nonfarm optional method, has gross nonfarm self-employment income of $2,000, with net earnings of $500. Farley can elect to report self-employment earnings of $1,333 (two-thirds of $2,000) rather than $500.

2.3 Retirement Benefits

2.3.1 Eligibility

Eligibility for Social Security retirement benefits is determined by the number of "Social Security credits" (previously called "quarters of coverage") earned by a worker from employment or self-employment subject to Social Security. The maximum number of Social Security credits that can be earned during a calendar year is four. For years prior to 1978, an individual generally earned one Social Security credit for each calendar quarter during which the individual earned $50 or more. Beginning in 1978, the amount of quarterly earning required to earn a Social Security credit has increased annually, from $250 per calendar quarter in 1978 to $1,000 per calendar quarter in 2007.

In order to achieve "fully insured status," which is required in order to receive Social Security retirement benefits, workers must earn the following number of Social Security credits:

A worker reaching age sixty-two in:	*Is fully insured if he or she has earned at least the following number of Social Security credits:*
1983	32
1984	33
1985	34
1986	35
1987	36
1988	37
1989	38
1990	39
1991 or later	40

Certain employees of nonprofit organizations who were at least fifty-five years old on January 1, 1984, can achieve "deemed fully insured status" with less than the number of Social Security credits set forth above.

Beginning October 1, 1999, the Social Security Administration (SSA) launched the largest customized mailing ever undertaken by a federal agency by sending out an annual Social Security Statement (formerly Personal Earnings and Benefit Estimate Statement) to 125 million workers who are ages twenty-five and older and not receiving

Social Security benefits. SSA staggered the mailing of the statements for workers to automatically receive their statements about three months before their birth month.

Practice Tip. If a worker has not received a Social Security statement, the worker or an authorized representative can obtain a printout of his or her Social Security credits, and an estimate of the worker's future Social Security retirement benefits, by completing Form SSA-7004-SM, Request for Earnings and Benefit Estimate. Copies of Form SSA-7004-SM can be obtained and submitted on the Internet at http://www.socialsecurity.gov.

2.3.2 Amount of benefit

The amount of a worker's OASDI benefits is based on the worker's "primary insurance amount" or PIA. A worker's PIA is calculated based on average taxable earnings over the worker's career and is designed to partially replace the income lost as a result of retirement, disability, or death. The actual mechanics of the PIA calculation are quite complicated and beyond the scope of this chapter. The Social Security Administration has produced a software program, known as ANYPIA, that will perform the calculations. Copies of ANYPIA can be obtained for $47 by calling (703) 605-6000, or can be downloaded free of charge from the Social Security Administration's Web site. For 2007, the average monthly Social Security retirement benefit for an individual worker is $1,044. For married couples both receiving benefits, the average monthly retirement benefit is $1,713.

2.3.2.1 Annual earnings limitation

Workers under full retirement age (The full retirement age for 2007 is 65 and 10 months). An individual receiving Social Security retirement benefits who has not reached full retirement age by the end of 2007 can receive up to $12,960 of earned income without a reduction of benefits. For each $2 of earned income above $12,960, the individual's retirement benefit will be reduced by $1.

Workers who have already reached full retirement in 2006 see no reduction in the amount of the monthly benefit no matter how much the worker earned after reaching full retirement age.

In 2007 if the worker reaches full retirement age (see Section 2.3.2.2 for definition of *full retirement age*), the benefits will be reduced $1 for every $3 the worker earned over $34,440 (2007) until the month the worker reached full retirement age. Therefore, if the earned income in the months preceding full retirement age was less than $34,440 (2007), there would be no reduction in Social Security benefits.

In most cases it pays for an individual who is continuing to work beyond full retirement age to start to collect his or her Social Security

at full retirement age, and not defer higher benefits payable at age seventy. An individual who defers benefits would have to reach age eighty-five before the total payments received equal payments that would have been received if the benefits started at full retirement age.

> **Planning Tip.** In 2007 if a worker who attains age 65 and 10 months and delays payments until age seventy, an individual can bump up retirement credit by 7.5 percent a year, so that by waiting until age seventy to collect Social Security, the individual's maximum monthly income will increase from $2,116.00 to about $2,880.00. This should be considered for someone who is planning to continue to work until age seventy and has a younger spouse who has limited working experience. By waiting to start drawing benefits, it will give a spouse a bigger pension to live on after the death of the working spouse.

To qualify for the special monthly benefit, an individual cannot perform substantial services in self-employment before age sixty-five. Substantial services are judged based on amount of time devoted to business, type of service rendered, and how services rendered compare with those performed in the past. Work totaling more than forty-five hours in a month is generally considered substantial. Work of fewer than fifteen hours in a month is not considered substantial. Consulting services of fifteen hours or more per month performed by the former owner of a business are generally treated as substantial services.

What counts as earnings. For purposes of the limitations on earned income discussed above, the following amounts are treated as earnings:

- — Gross wages earned by an employee during the year (regardless of when received by the employee)
- — Net earnings from self-employment received during the year (regardless of when they are earned)
- — Cash tips of $20 or more per month
- — Director's fees

For purposes of the limitations on earned income discussed above, the following amounts are generally *not* treated as earnings:

- — Passive income (such as interest, dividends, and rent from real estate activities in which a nondealer did not materially participate)
- — Gain from the sale of capital assets
- — Retirement income (such as payments from an IRA, pension plan, and certain trusts and annuity plans that are exempt from tax)
- — Retirement payments received by retired partners from a partnership if:

- The retirement payments are to continue for life under a written agreement that provides for payments to all partners (or to a class or classes of partners)
- The partner's share of capital was paid in full before the end of the partnership's taxable year and there is no obligation from the partnership to the partner except to make retirement payments

— Social Security benefits

— Sick pay received more than six months after the last month in which the worker performed services

— Workers' compensation and other unemployment compensation benefits

2.3.2.2 Early or delayed retirement

Full retirement age. The amount of a worker's Social Security retirement benefit depends on whether the worker retired before, at, or after the worker's "full retirement age" as listed on the following chart:

For a worker born in:	*Full retirement age is:*
1937 or earlier	65
1938	65 and 2 months
1939	65 and 4 months
1940	65 and 6 months
1941	65 and 8 months
1942	65 and 10 months
1943 through 1954	66
1955	66 and 2 months
1956	66 and 4 months
1957	66 and 6 months
1958	66 and 8 months
1959	66 and 10 months
1960 and later	67

For surviving spouse see Section 2.4.2 for definition of full retirement age.

Early retirement. A worker who has achieved fully insured status can elect to begin receiving reduced Social Security retirement benefits for the first month following the month of his or her sixty-second birthday. If a worker elects to receive early retirement benefits, the retirement benefit payable to the worker is permanently reduced by a percentage that is determined based on the number of months between the month in which the worker first elects to receive early retirement benefits and the month in which the worker will attain full retirement age. The number of intervening months is then divided by 180 (up to a maximum

of 36 intervening months). Any intervening months in excess of 36 are then divided by 240.

The following chart details the amount of benefits received by taking early retirement.

For a worker born in:	*Worker will turn 62 in:*	*The percentage of benefits worker receives if worker takes early retirement (%)*
1937 and before	1999 and before	80
1938	2000	79⅙
1939	2001	78⅓
1940	2002	77½
1941	2003	76⅔
1942	2004	75⅚
1943–54	2005–16	75
1955	2017	74⅙
1956	2018	73⅓
1957	2019	72½
1958	2020	71⅔
1959	2021	70⅚
1960 and later	2022 and later	70

Example. Adams, a worker born in 1962, plans to begin receiving retirement benefits for the first full month following his sixty-second birthday. Adams' full retirement age is sixty-seven. Accordingly, there are sixty months between the month of his first payment and the month in which he will attain full retirement age. Thus, Adams' retirement benefits will be permanently reduced by 30 percent, calculated as follows: 36 months divided by 180 (20 percent), plus 24 months divided by 240 (10 percent).

If an individual earned 40 credits, he or she can start receiving Social Security benefits at age 62 or at any month between age 62 and full retirement age. However, the benefits will be permanently reduced based on the number of months the individual receives benefits before he or she reached full retirement age.

Example. If full retirement age is 66, the benefits will be reduced as follows:

25 percent at age 62;
20 percent at age 63;
13⅓ percent at age 64; or
6⅔ percent at age 65.

Delayed retirement. A worker electing to delay receipt of Social Security retirement benefits beyond full retirement age is entitled to a "delayed retirement credit" which permanently increases the retirement benefit payable to the worker. The delayed retirement credit is

earned for each month during which a fully insured worker has attained full retirement age, but has not yet attained age seventy, and elects not to receive Social Security retirement benefits. The amount of the delayed retirement credit that can be earned by a worker is set forth on the following chart and depends on the year of birth.

Year of birth:	*The monthly delayed retirement credit is:*	*Yearly rate of increase:*
1931–1932	5/12 of 1%	5.0%
1933–1934	11/24 of 1%	5.5%
1935–1936	1/2 of 1%	6.0%
1937–1938	13/24 of 1%	6.5%
1939–1940	7/12 of 1%	7.0%
1941–1942	5/8 of 1%	7.5%
1943 or later	2/3 of 1%	8.0%

Example. Baker, a worker who attained age 65 in 2001, elects not to receive retirement benefits until the month in which he attains age seventy. Baker's full retirement age is sixty-five. Baker's retirement benefit will be permanently increased by 30 percent, calculated as follows: 60 months multiplied by 1/2 of 1 percent (.05) or 5 years at 6.0% per year.

Planning considerations. The decision of whether to take reduced early retirement benefits, normal retirement benefits, or the delayed retirement benefit will depend on a number of factors, the most important being whether the benefit will be reduced or eliminated because of the annual earnings limitations described in Section 2.3.2. Another important consideration is that a worker electing to receive early retirement benefits will receive benefits for a longer period of time than a worker who waits until full retirement age or beyond. As a general rule of thumb, it will be twelve to fifteen years after full retirement age before the aggregate increased benefit payable at full retirement age exceeds the aggregate benefit payable at the reduced early retirement rate.

Example. Carter is entitled to receive retirement benefits of $600 per month beginning at his full retirement age of sixty-five. Carter can elect to receive reduced retirement benefits of $480 per month (80 percent of $600) beginning at age sixty-two. If Carter elects to receive full retirement benefits, then by age seventy-seven he will have received total benefits of $86,400 (144 months times $600 per month). If Carter elects to receive reduced early retirement benefits, then by age seventy-seven he will have received the same amount of total benefits (180 months times $480 per month).

Reasons to take Social Security early:

- Can earn high returns investing the money;
- Worker is in poor health; and
- Worker needs the money to retire.

Reasons to delay:

- Worker wants to ensure a big survivor's benefit for his or her spouse;
- Worker's life expectancy is good; and
- Still working and does not need the benefits.

2.3.2.3 Maximum family benefit

The maximum retirement benefit payable to a retired worker and his or her family is computed based on the worker's PIA. For 1998, the maximum family benefit is equal to:

- 150 percent of the first $609 of the worker's PIA, plus
- 272 percent of PIA over $609 up to $880, plus
- 134 percent of PIA over $880 up to $1,147, plus
- 175 percent of PIA over $1,147.

If the worker's PIA is $1,600, the monthly computation of maximum family benefit is as follows:

150% ×	609	=	914
272% ×	271	=	737
134% ×	267	=	358
175% ×	493	=	793
	1,600	=	2,802

2.3.3 Dependent coverage

The spouse, former spouse, and children of a worker may be entitled to Social Security retirement benefits based on the earnings history of the worker.

2.3.3.1 Spouse

The spouse of a worker may be entitled to Social Security retirement benefits based on the earnings history of the worker in the following circumstances:

— The worker has achieved fully insured status.

— The spouse has filed an application for spouse's benefits.

— The spouse is not entitled to a retirement benefit based on a PIA that equals or exceeds one-half of the worker's PIA.

— The spouse is either (a) age sixty-two or over; or (b) caring for a child under age sixteen or a disabled child who is entitled to benefits based on the worker's earnings history.

— The spouse meets one of the following requirements:

- The spouse has been married to the worker for at least one year at the time of the application for benefits.
- The spouse is the natural parent of a natural child of the worker.
- The spouse was entitled or potentially entitled to certain benefits under the Social Security Act or the Railroad Retirement Act.

The retirement benefit payable to an eligible spouse is based on his or her own work record, or half of the benefit amount of the worker, whichever is greater. In addition, if the worker has elected to take reduced early retirement benefits, the spouse's benefit will be reduced in a similar (but not identical) fashion. To determine the benefit value for the spouse, Social Security uses the benefit each spouse would be entitled to at a full retirement age. It does not count the increase the worker received by delaying benefits.

> *Example.* John's benefits would have been $1,000 a month at age 65, but he decided to continue to work. When he finally elected benefits, his benefit was higher for a total benefit of $1,500 a month. If his spouse wanted to claim half his benefit, she would receive $500 (half his full retirement age benefit—not $750).

2.3.3.2 Former spouse

In addition to the spouse, the former spouses of a worker may be entitled to Social Security retirement benefits on the basis of the worker's earnings history in the following circumstances:

— Either (a) the worker has achieved fully insured status, or (b) the former spouse has achieved fully insured status and has been divorced from the worker for at least two continuous years

— The former spouse has filed a claim for former spouse's benefits

— The former spouse is not entitled to a retirement benefit based on a PIA that equals or exceeds one-half of the worker's PIA

— The former spouse is age sixty-two or over

— The former spouse is not married

— The former spouse had been married to the worker for at least ten years prior to the date of divorce

2.3.3.3 Child

A natural or adopted child of a worker (and, in some cases, a grandchild or stepgrandchild of a worker) may be entitled to Social Security retirement benefits on the basis of the worker's earnings history in the following circumstances:

— The worker has achieved fully insured status

— The child is dependent upon the worker

— An application for child's insurance benefits is filed

— The child is unmarried

— The child is either (a) under age eighteen; (b) age eighteen to nineteen and a full-time elementary or secondary school student; or (c) age eighteen or over and disabled.

2.3.4 Taxation of retirement benefits

The taxation of Social Security retirement benefits (and Tier 1 Railroad Retirement Benefits) is governed by Section 86 of the Internal Revenue Code.

50 percent inclusion. Section 86 generally provides that a worker is taxable on the lesser of:

— One-half of the retirement benefits received during the year

— One-half of the excess of (a) the worker's "provisional income" for the year over (b) the "base amount"

A worker's "provisional income" is equal to the sum of:

— The worker's adjusted gross income for the year; plus

— Any tax-exempt interest earned by the worker during the year; plus

— Any amounts earned by the worker during the year in a foreign country, U.S. possession, or Puerto Rico that are excluded from gross income; plus

— One-half of the worker's Social Security benefits for the year.

For 2007, the base amount is:

— $32,000 for a married worker filing jointly.

— $0 for a worker who is married at the end of the year, does not file a joint return, and lives with his or her spouse at any time during the year.

— $25,000 for any other worker.

Example: Davis is an unmarried worker receiving annual Social Security retirement benefits of $10,000. Davis has adjusted gross income for the year of $21,000 and receives $4,000 of tax-exempt interest during the year. Davis' provisional income for the year is $30,000 ($21,000 + $4,000 + 1/2 of $10,000). Accordingly, Davis is taxable on the lesser of (a) $5,000 (1/2 of his retirement benefits) or (b) $2,500 (1/2 of the excess of $30,000 provisional income over $25,000 base amount).

85 percent inclusion. Workers with provisional income in excess of the "adjusted base amount" are subject to inclusion of up to 85 percent of Social Security retirement benefits. For 2007, the adjusted base amount is:

— $44,000 for a married worker filing jointly.

— $0 for a worker who is married at the end of the year, does not file a joint return, and lives with his or her spouse at any time during the year.

— $34,000 for any other worker.

For those workers, the amount of Social Security retirement benefits includable in gross income is equal to the lesser of:

(Text continued on page 15)

— 85 percent of the retirement benefits received during the year

— The sum of:

- 85 percent of the excess of provisional income over the adjusted base amount; plus
- The lesser of (x) the amount that would be taxable under the 50 percent inclusion test, or (y) one-half of the difference between the adjusted base amount and the base amount (currently $6,000 for married workers filing jointly, $4,500 for unmarried workers).

Example: Evans is an unmarried worker receiving Social Security retirement benefits of $12,000 for the year. She has adjusted gross income of $40,000 for the year and receives $5,000 of tax-exempt interest for the year. Because Evans has provisional income in excess of $34,000, she is subject to the 85 percent inclusion provisions. Nonetheless, the first step in calculating the portion of Evans' retirement benefits that are subject to tax is to calculate the result under the 50 percent inclusion provisions as follows:

Provisional income	$51,000
Less base amount	(25,000)
Excess provisional income	$26,000
Divided by 2	$13,000
1/2 of retirement benefits	$ 6,000

Thus, under the 50 percent inclusion provisions, Evans is subject to tax on $6,000 of retirement benefits. Under the 85 percent inclusion provisions, Evans is subject to tax on the lesser of (a) $10,200 (85 percent of retirement benefits) or (b) $18,950 (the sum of (x) $14,450 [85 percent of the excess of $51,000 provisional income over $34,000 adjusted base amount] plus (y) the lesser of (i) $6,000 [as determined above under the 50 percent inclusion rules] or (ii) $4,500). Thus, Evans is taxable on $10,200 of retirement benefits.

2.3.5 Applying for retirement benefits

In order to receive Social Security retirement benefits before full retirement age, a worker must file an application with the Social Security Administration. The application, which should be filed by the last day of the first month for which the worker desires to receive benefits, can generally be completed over the telephone by calling a local Social Security office. A worker who chooses not to apply for retirement benefits prior to reaching full retirement age should contact the Social Security Administration two to three months prior to reaching full retirement age, even if he or she is not planning to retire.

2.4 Survivor's Benefits

In addition to the retirement benefit discussed above, Social Security benefits may also be payable to a spouse, former spouse, child, or parent of a deceased worker in the circumstances described below.

2.4.1 Lump-sum death benefit

Upon the death of a worker who is fully insured or "currently insured," a lump-sum payment of $255 is payable to a surviving spouse of the worker who was living in the same household as the worker at the time of the worker's death or was eligible for or entitled to survivor's benefits (as discussed below) based on the worker's earnings history at the time of the worker's death. If there is no eligible surviving spouse of the worker, the lump-sum death benefit is payable to minor children of the worker who are eligible for or entitled to survivors' benefits based on the worker's earnings history at the time of his or her death. The lump-sum death benefit is payable in addition to any other survivor's benefits that may be payable to the recipient. A surviving spouse or child generally must apply to receive the lump-sum death benefit within two years after the worker's death.

For purposes of the Social Security Act, a worker is "currently insured" if he or she has earned at least six Social Security credits during the full thirteen-quarter period ending with the calendar quarter in which the worker:

— Died.

— Most recently became entitled to Social Security disability benefits.

— Became entitled to Social Security retirement benefits.

2.4.2 Surviving spouse

A surviving spouse of a deceased worker may be entitled to a survivor's benefit based on the worker's earnings history if:

— The spouse is age sixty or over (or age fifty or over and disabled).

— The worker was fully insured at the time of death.

— The spouse is not entitled to a Social Security retirement benefit that is equal to or larger than the worker's PIA.

— The spouse has filed a claim for survivor's benefits.

— The spouse is not married (waived if the marriage occurs after the spouse is age sixty [or after age fifty if disabled]).

— One of the following conditions (the "survivors conditions") is satisfied:

- The spouse was married to the worker for at least nine months prior to the worker's death.
- The spouse is the biological parent of a child of the worker.
- The spouse legally adopted a child of the worker during the marriage and before the child reached age eighteen.
- The spouse was married to the worker at the time they both adopted a child under age eighteen.
- The worker legally adopted a child of the spouse during the marriage and before the child reached age eighteen.
- The spouse was potentially entitled to Social Security benefits during the month before the spouse married the worker.

The amount of a surviving spouse's benefit is 100 percent of the worker's PIA subject to reduction or elimination by the maximum family benefit limitation or the limitation on annual earnings. In addition, if a surviving spouse elects to receive spouse's benefits prior to full retirement age, the amount of the benefit is permanently reduced by a certain percentage for each month that benefits are payable prior to full retirement age. Full retirement age for a surviving spouse is not the same as full retirement age for retirement benefits. See Section 2.3.2.2 for the definition of full retirement age for retirement benefits.

For surviving spouse born in:	*Full retirement age is:*	*Monthly % Reduction**
1939 or earlier	65	.475
1940	65 and 2 months	.460
1941	65 and 4 months	.445
1942	65 and 6 months	.432
1943	65 and 8 months	.419
1944	65 and 10 months	.407
1945–1956	66	.396
1957	66 and 2 months	.385
1958	66 and 4 months	.375
1959	66 and 6 months	.365
1960	66 and 8 months	.356
1961	66 and 10 months	.348
1962	67	.339

*Monthly reduction percentages are approximate due to rounding. The total % reduction for anyone who receives benefits at age 60 is always 28.50.

(Text continued on page 17)

If a surviving spouse does not qualify for a survivor's benefit based on the worker's earnings history, the spouse may still be entitled to a mother's or father's benefit based on the worker's earnings history if:

— The spouse is caring for a child of the deceased worker who is under age sixteen or disabled and who is entitled to child's benefits based on the worker's earnings history.
— The worker was fully insured or currently insured at the time of death.
— The spouse has filed an application for mother's or father's benefits.
— The spouse is not entitled to a Social Security retirement benefit that is equal to or larger than the amount of the mother's or father's benefit.
— The spouse is not married.
— One of the "survivors conditions" described above is satisfied.

The amount of the father's or mother's benefit is equal to 75 percent of the worker's PIA, subject to reduction or elimination by the maximum family benefit limitation or the limitation on annual earnings.

2.4.3 Surviving divorced spouse

A surviving divorced spouse of a deceased worker may be entitled to a survivor's benefit based on the worker's earnings history if:

— The former spouse is age sixty or over (or age fifty or older and disabled).
— The worker was fully insured at the time of death.
— The former spouse is not married at the time of the worker's death (waived in the case of certain accidental deaths or if remarriage occurs after age sixty [age fifty if disabled]).
— The former spouse is not entitled to a Social Security retirement benefit that is equal to or greater than the worker's PIA.
— The former spouse filed a claim for survivor's benefits.
— The former spouse was married to the worker for at least ten years at the time the divorce became final.

The amount of the former spouse's benefit is calculated in the same manner described above for a surviving spouse.

If a surviving divorced spouse does not qualify for a former spouse's benefit based on the worker's earnings history, the former spouse may still be entitled to a mother's or father's benefit based on the worker's earnings history if:

— The former spouse is caring for a child of the deceased worker who is the natural or legally adopted child of the former spouse and who is under age sixteen or disabled and who is entitled to child's benefits based on the worker's earnings history.

— The worker was fully insured or currently insured at the time of death.

— The former spouse has filed an application for mother's or father's benefits.

— The former spouse is not entitled to a Social Security retirement benefit that is equal to or larger than the amount of the mother's or father's benefit.

— The former spouse is not married.

— One of the "survivors conditions" described above is satisfied.

The mother's or father's benefit payable to a surviving former spouse is calculated in the same manner described above for a surviving spouse who is entitled to mother's or father's benefits.

2.4.4 Surviving child

A surviving child of a deceased worker may be entitled to a survivor's benefit based on the worker's earnings history if:

— The worker was fully insured or currently insured at the time of death.

— The child was dependent on the deceased worker.

— The child is not married.

— A claim for child's insurance benefit is filed on behalf of the child.

— One of the following conditions is satisfied:

- The child is under age eighteen.
- The child is under age nineteen and a full-time elementary or secondary school student.
- The child is age eighteen or older and under a disability that began before age twenty-two.

The amount of the child's benefit is 75 percent of the worker's PIA, subject to reduction or elimination by the maximum family benefit limitation.

2.4.5 Surviving parent

A surviving parent of a deceased worker may be entitled to a survivor's benefit based on the worker's earnings history if:

— The worker was fully insured at the time of death.

— The parent files an application for parent's benefits.

— The parent has reached age sixty-two.

— The parent is not entitled to a Social Security retirement benefit that is equal to or larger than the amount of the parent's insurance benefit payable.

— The parent was receiving at least one-half support from the worker (evidence of such support must be filed with the Social Security Administration within a specified time period).

— The parent has not remarried following the worker's death.

— One of the following conditions is met:

  - The parent is the natural parent of the worker.
  - The parent had legally adopted the worker before the worker reached age sixteen.
  - The parent became the worker's stepparent by a marriage ended before the worker reached age sixteen.

The amount of the parent's benefit is 82½ percent of the worker's PIA if only one parent is entitled to parent's benefits. If more than one parent is entitled to parent's benefits, the amount is 75 percent of the worker's PIA for each parent. In each case, the amount of the parent's benefit is subject to reduction or elimination by the maximum family benefit limitation or the limitations on excess earnings.

2.5 Disability Benefits

2.5.1 Eligibility

Disabled worker. A worker who is "disabled" within the meaning of the Social Security Act (as discussed below) may be entitled to Social Security disability benefits if the worker has achieved "disability insured status." To achieve that status, a worker must satisfy each of the following conditions:

— The worker has earned at least twenty Social Security credits during the forty-quarter period that ends with the quarter in which the worker is determined to be disabled.

— The worker has earned at least one Social Security credit for each calendar year after 1950 (or, if later, after the year in which the worker attained age twenty-one).

In addition to achieving disability insured status, a disabled worker must file an application for disabled worker's benefits and complete a waiting

period of five consecutive full calendar months before receiving disability benefits. The five-month waiting period is waived for certain workers who had been entitled to disabled worker's benefits within the previous five years.

Disabled child or surviving spouse. Under certain circumstances, a disabled child of a worker may be entitled to Social Security disability benefits if the child became disabled before age twenty-two. In addition, a disabled surviving spouse or surviving former spouse of a worker may be entitled to disability benefits.

Nondisabled dependents. Social Security benefits may be available to nondisabled dependents of a disabled worker (a) if an unmarried child of a disabled worker is under age eighteen; or (b) if a spouse of a disabled worker is caring for a child of the disabled worker who is under age sixteen (or disabled) and is receiving benefits based on the worker's earnings history.

2.5.2 Disability benefits

The Social Security disability benefit is generally equal to the full amount of the worker's PIA. The benefit may be reduced, however, in any of the following circumstances:

— The sum of the Social Security disability benefit plus any worker's compensation benefits or other disability benefits payable to the worker under a federal, state, or local public law program exceeds 80 percent of the worker's "average current earnings."

— The worker becomes disabled after electing to receive reduced Social Security retirement benefits.

— The benefit is limited by the maximum family benefit limitation.

Social Security disability benefits generally continue until the earliest of:

— The second month after the disability ceases.

— The month before the month in which the recipient attains age sixty-five (after which the benefits are converted into Social Security Retirement benefits).

— The month before the month in which the recipient dies.

2.5.3 Definition of disability

For purposes of the Social Security Act, a disability is defined as "the inability to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be

expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months."

Substantial gainful activity. Substantial gainful activity must involve the performance of physical or mental activities that are productive in nature and that are performed for remuneration or profit. A special definition of substantial gainful activity applies to individuals disabled by blindness. The determination of whether an individual has engaged in substantial gainful activity is generally made by reference to the amount of earnings received from the performance of the activity. As a rule of thumb, earnings of $900 or more per month from an activity generally demonstrate that the activity is substantial and gainful. Earnings of less than $300 per month from an activity demonstrate that the activity is not substantial and gainful.

Physical or mental impairment. The regulations issued under the Social Security Act contain a "Listing of Impairments" that identifies physical or mental conditions that, absent evidence to the contrary (such as excess earnings), generally establish that an individual is unable to engage in substantial gainful activity. Examples of such conditions include:

— Diseases of the heart, lungs, or blood vessels that have resulted in serious loss of heart or lung reserves as shown by X-ray, electrocardiogram, or other tests and, in spite of medical treatment, there is breathlessness, pain, or fatigue.

— Severe arthritis that causes recurrent inflammation, pain, swelling, and deformity in major joints so that the ability to get about or use the hands is severely limited.

— Mental illness resulting in marked constriction of activities and interests, deterioration in personal habits or work-related situations, and seriously impaired ability to get along with other people.

— Damage to the brain or brain abnormality that has resulted in severe loss of judgment, intellect, orientation, or memory.

— Cancer that is progressive and has not been controlled or cured.

— Diseases of the digestive system that result in severe malnutrition, weakness, and anemia.

— Acquired immunodeficiency syndrome (AIDS).

— Progressive diseases that have resulted in the loss of a leg or have caused it to become useless.

— Loss of major function of both arms, both legs, or a leg and an arm.

— Serious loss of function of the kidneys.

— Total inability to speak.

Trial work period. An individual receiving Social Security disability benefits who continues to be disabled is entitled to a trial work period of nine months (which need not be consecutive). During that period, any work and earnings are disregarded for purposes of determining whether the individual continues to be disabled. Any month during which the individual performs "insignificant work" does not count as part of the nine-month trial work period. For these purposes, an individual is considered to have performed insignificant work for any month in which (a) the individual's earnings from employment are $200 or less, or (b) the individual's earnings from self-employment are $200 or less and the individual spends forty hours or less in the performance of self-employment.

Determination of disability. The determination of whether a person is disabled for purposes of the Social Security Act is made by the Disability Determination Services (DDS) office in the person's home state. The DDS employs physicians and other specialists to evaluate the person's condition. If the DDS determines that a person is not disabled, the person can appeal the decision in writing to any Social Security office within sixty days after receipt of notice from the DDS.

If the DDS determines that a person is disabled, the DDS will review the person's condition periodically to determine whether the disability has ceased. Reviews are generally scheduled as follows:

— If improvement is expected: first review scheduled six to eighteen months after initial disability determination

— If improvement is possible: once every three years

— If improvement is not expected: once every five to seven years

If, following a review, the DDS determines that a person is no longer disabled, disability benefits will cease after the second month following the month in which the disability terminated. If the person disagrees with the determination, he or she can file an appeal in writing with any Social Security office within sixty days after the determination. If the person appeals within ten days after the determination, disability benefits will continue during the appeal. If the appeal is denied, the person may be required to return payments received during the appeal period.

3. SUPPLEMENTAL SECURITY INCOME

3.1 Introduction

In addition to the other benefits described in this chapter, the Social Security Act provides for Supplemental Security Income (SSI) for individuals with limited income and resources who are age sixty-five or

older, blind, or disabled. Unlike OASDI benefits, which are financed through FICA and self-employment taxes, SSI is funded from general funds of the U.S. Treasury. SSI benefits are available to elderly, blind, or disabled individuals having "resources" (as discussed below) of $2,000 or less ($3,000 or less for married couples) and having monthly income that is less than the maximum federal monthly SSI benefit payable. The amount of SSI benefits payable to an eligible recipient depends on the income and living arrangements of the recipient. For 2007, the maximum monthly federal SSI benefit is $623 for an individual without an eligible spouse and $934 for an eligible married couple. In addition, some states supplement federal SSI benefits payable to state residents. For example, a person who receives SSI may be able to get Medicaid, food stamps, or some other social services.

3.2 Resources

For purposes of SSI, resources generally include cash and other liquid assets and any other property that an individual or the individual's spouse could convert to cash to obtain support and maintenance. The following items, however, are not counted as resources:

- An individual's principal place of residence (regardless of value)
- One wedding ring and one engagement ring (regardless of value)
- Items needed because of a person's physical condition (such as a wheelchair or prosthetic devices)
- Other resources having an aggregate value of less than $2,000, and $3,000 for a couple
- One automobile, regardless of value, if used to provide necessary transportation, or, if not so used, to the extent its current market value does not exceed $4,500
- Certain life insurance with a face value of $1,500 or less for each spouse
- Burial spaces and certain burial funds of up to $1,500

3.3 Income

For SSI purposes, monthly income generally includes all earned or unearned income, and the value of property or services, actually or constructively received by an individual during the month. The following items, however, are generally not treated as income:

- Medical care and services
- Social services

— Gain from the sale, exchange, or replacement of a resource
— Income tax refunds
— Loan proceeds

Even if an item is treated as income for SSI purposes, there are numerous exclusions for items of income that are not counted for purposes of SSI monthly income limitation (including most payments under federal assistance programs).

3.4 Reporting Requirements

Persons receiving SSI benefits are responsible for reporting changes that could affect the amount of their benefits. Reports can be made by phone, by mail, or in person and must be made by within ten days after the end of the month in which the change occurred. Fines of up to $100 are imposed for failing to report changes timely. In addition, criminal penalties (including imprisonment) can be imposed on a person who intentionally makes false statements on an SSI report.

An individual must file a report if he or she:

— Moves or changes address.
— Has a change in his or her household.
— Has a change in income.
— Has a change in resources.
— Receives help with living expenses.
— Leaves the United States.
— Marries or ends a marriage.
— Has a change in citizenship or alien status.
— Improves in condition while receiving benefits based on disability or blindness.
— Starts or stops attending school.
— Violates a condition of parole.
— Becomes eligible for any other benefits.

In addition, many states impose additional SSI reporting requirements.

4. MEDICARE

4.1 Introduction

Medicare is a federal health insurance program for people sixty-five or older, people of any age with permanent kidney failure, or people with

certain other disabilities. Medicare is administered by the Health Care Financing Administration (HCFA) and covers eligible recipients receiving medical or hospital care anywhere in the United States (including the District of Columbia, Puerto Rico, the Virgin Islands, Guam, and American Samoa). Medicare is divided into two parts: hospital insurance (Part A) and medical insurance (Part B). Hospital insurance helps pay for inpatient hospital care and certain outpatient follow-up care and is financed by the hospital insurance portion of the FICA and self-employment tax. Medical insurance helps pay for doctors' services and other medical services and is financed by the monthly premiums paid by people enrolled in the program (see section 4.3.1, below) and by general federal revenues.

4.2 Medicare Hospital Insurance (Part A)

4.2.1 Eligibility

To be eligible for Medicare hospital insurance coverage, people age sixty-five or older must meet at least one of the following criteria:

— They are entitled to monthly Social Security or railroad retirement benefits.

— They have worked long enough to be insured under Social Security or the railroad retirement system.

— They have worked long enough in federal employment (see the table at the end of this section) to be insured for Medicare purposes.

People are entitled to coverage before sixty-five if they meet one of the following conditions:

— They have been entitled to Social Security disability benefits for twenty-four months.

— They have worked long enough in federal employment and meet the requirements of the Social Security disability program.

People are eligible at any age if they need maintenance dialysis or a kidney transplant for permanent kidney failure and:

— Are insured or getting monthly benefits under Social Security or the railroad retirement system.

— Have worked long enough in federal employment.

Spouses and children of workers may also be eligible for maintenance dialysis or kidney transplant. Under certain conditions spouses, divorced spouses, widows, widowers, or dependent parents of a worker may be

eligible for hospital insurance at age sixty-five based on the worker's earnings history. This may also apply to disabled widows or widowers under sixty-five, disabled surviving divorced spouses under sixty-five, and disabled children eighteen or older.

WORK CREDITS NEEDED FOR FEDERAL EMPLOYEES

If you reach age 65 in	*Years you need*
1983	7¼
1984	7½
1986	8
1990	9
1994 or later	10

People receiving Social Security or railroad retirement checks do not have to apply for hospital insurance; it will begin automatically at age sixty-five (except for federal employees, who should apply three months before their sixty-fifth birthday). People who plan to keep working after age sixty-five should also file an application three months prior to turning sixty-five. Those not eligible for coverage at sixty-five because they do not have enough work credits or are not receiving benefits can purchase hospital insurance for a monthly premium of $410.00 for workers with less than thirty Social Security credits; $226.00 per month for workers with thirty to thirty-nine Social Security credits in 2007 (provided that they also purchase medical insurance). People with permanent kidney failure should apply for Medicare as soon as the condition appears. There is a twenty-four-month waiting period for disabled workers under sixty-five and a two-month waiting period for people receiving maintenance dialysis treatment.

4.2.2 Coverage

Hospital coverage (per benefit period) provides benefits for inpatient care, skilled-nursing-facility care, home health care, and hospice care. A benefit period commences on the day the beneficiary enters a hospital and ends 60 days after the termination of hospitalization or skilled nursing care. If a person needs in-patient hospital care, Medicare hospital insurance covers the first ninety days of a hospital stay and includes sixty additional lifetime reserve days that can be used at the discretion of the patient. After the patient has been out of the hospital or skilled nursing care for 60 days, a new benefit period can begin. Coverage includes:

— Semiprivate room and board (no television or telephone).

— General nursing service.

— Lab tests, X-rays, other radiology services, and radiation therapy.

— Drugs furnished by the hospital.

— Medical supplies.

— Rehabilitation services.

— Cost of special-care units.

— Blood transfusions after the first three pints.

For patients requiring home health services, Medicare coverage includes:

— Part-time skilled nursing care.

— Physical and speech therapy.

— Medical supplies and services provided by an agency.

— Occupational therapy.

Skilled nursing facility care and hospice care are also available to patients whose conditions require these services.

The following chart summarizes the hospital insurance-covered services, and the patient's financial obligations for 2007.

MEDICARE (PART A): HOSPITAL INSURANCE-COVERED SERVICES

Services	*Benefit*	*Medicare Pays*	*Patient Pays*
HOSPITALIZATION Semiprivate room and board, general nursing, and miscellaneous hospital services and supplies. (Medicare payments based on benefit periods.)	First 60 days	All but $992	$992
	61st to 90th day	All but $248 a day	$248 a day
	91st to 150th day*	All but $496 a day	$496 a day
	Beyond 150 days	Nothing	All costs
SKILLED NURSING FACILITY CARE Patient must have been in a hospital for at least 3 days and must enter a Medicare-approved facility generally within 30 days after hospital discharge.† (Medicare payments based on benefit periods.)	First 20 days	100% of apprvd. amt.	Nothing
	Additional 80 days	All but $124.00 a day	$124.00 a day
	Beyond 100 days	Nothing	All costs

Services	*Benefit*	*Medicare Pays*	*Patient Pays*
HOME HEALTH CARE Medically necessary skilled care.	Part-time or intermittent care for as long as patient meets Medicare conditions.	100% of approved amount; 80% of approved amount for durable medical equipment.	Nothing for services; 20% of approved amount for durable medical equipment.
HOSPICE CARE Pain relief, symptom management, and support services for the terminally ill.	As long as doctor certifies need.	All but limited costs for out-patient drugs and inpatient respite care.	Limited cost sharing for outpatient drugs and inpatient respite care.
BLOOD	Unlimited if medically necessary.	All but first 3 pints per calendar year.	For first 3 pints.‡

* This 60-reserve-days benefit may be used only once in a lifetime.
† Neither Medicare nor private Medigap insurance will pay for most nursing home care.
‡ To the extent that the blood deductible is met under one part of Medicare during the calendar year, it does not have to be met under the other part.

Source: U.S. Department of Health and Human Services, Social Security Administration.

4.3 Medicare Medical Insurance (Part B)

4.3.1 Eligibility

People eligible for hospital insurance will automatically be enrolled for medical insurance unless they specifically refuse it at the time they become eligible for hospital insurance.

Starting in 2007, affluent Medicare recipients, based on their income, for the first time will pay more than $93.50 standard premium a month (for 2006 it was $88.50) due to the new income-based changes as part of the same 2003 law that created the new prescription drug benefit. Means testing of Part B premium was one of the most controversial elements of the 2003 Medicare Modernization Act. This change will affect about 1.5 million of the 42.5 million Medicare beneficiaries (3.5%) and save the program $20.8 billion in the next ten years. In 2008 and 2009, the surcharge will increase substantially because the full surcharge is being phased in over three years. The following chart illustrates the premium for 2007.

Individual	*Married Couples*	*Total Monthly Premium*[1]	
2005 Modified AGI[2]	*2005 Modified AGI*[2]	*2006*	*2007*
Up to 80,000	Up to 160,000	88.50	93.50
80,001 to 100,000	160,000 to 200,000	88.50	105.80
100,001 to 150,000	200,001 to 300,000	88.50	124.40
150,001 to 200,000	300,001 to 400,000	88.50	142.90
Over 200,000	Over 400,000	88.50	161.40

[1]Premiums for each spouse covered under Medicare.
[2]2005 Modified AGI is adjusted gross income plus tax exempt interest, EE Bond interest used for education expenses and excluded foreign earned income.

People who must apply for medical insurance include:

— People planning to work past full retirement age who are not receiving retirement benefits but need Medicare for health insurance.

— People at full retirement age who are not eligible for hospital insurance.

— People with permanent kidney failure.

— People eligible for Medicare on the basis of federal employment.

Planning Tip. Low income individuals may be eligible for the Qualified Medicare Beneficiary Program which pays for all out-of-pocket expenses (premiums, deductibles, copayments) for which the individual would otherwise be responsible.

(Text continued on page 29)

The initial enrollment period for the worker and his or her spouse begins three months before the month of the applicant's full retirement age and continues three months after that date. For each year that a worker fails to enroll during a period of eligibility, there is a 10 percent penalty for premium cost unless the worker is covered by health insurance based on current employment.

4.3.2 Coverage

Medical insurance coverage provides for doctors' services and many other medical services and includes:

— Medical and surgical treatment.

— Services of a doctor's nurse.

— Physical and occupational therapy.

— Speech therapy.

— Drugs and biologicals that must be administered by a doctor or nurse (which excluded most prescription drugs that can be taken without the involvement of medical personnel).

— Medical supplies and equipment (does not include basic first-aid equipment).

— Medically required ambulance services (if other forms of transport would cause injuries to the patient).

— Blood transfusions provided on an outpatient basis.

— Diabetes glucose monitoring and education.

The following chart summarizes medical insurance-covered services, and the patient's financial obligations, for 2007.

MEDICARE (PART B): MEDICAL INSURANCE-COVERED SERVICES

Services	*Benefit*	*Medicare Pays*	*Patient Pays*
MEDICAL EXPENSES Doctors' services, inpatient and outpatient medical and surgical services and supplies, physical and speech therapy, ambulance, diagnostic tests, and more.	Medicare pays for medical services in or out of the hospital.	80% of approved amount (after $131 deductible).	$131 deductible,* plus 20% of approved amount and limited charges above approved amount.†
CLINICAL LABORATORY SERVICES Blood tests, biopsies, urinalyses, and more.	Unlimited if medically necessary.	100% of approved amount.	Nothing for services.

Services	*Benefit*	*Medicare Pays*	*Patient Pays*
HOME HEALTH CARE Medically necessary skilled care.	Part-time or intermittent skilled care for as long as patient meets conditions for benefits.	100% of approved amount; 80% of approved amount for durable medical equipment.	Nothing for services; 20% of approved amount for durable medical equipment.
OUTPATIENT HOSPITAL TREATMENT Services for the diagnosis or treatment of illness or injury.	Unlimited if medically necessary.	80% of approved amount (after $131 deductible).	$131 deductible, plus 20% of billed charges.
BLOOD	Unlimited if medically necessary.	80% of approved amount (after $131 deductible and starting with 4th pint).	First 3 pints plus 20% of approved amount for additional pints (after $131 deductible).‡

* The patient pays the first $131 each year of expenses for covered services. Thereafter, Medicare Part B pays 80% of covered expenses.

† Physicians who do not accept assignment of Medicare claims are limited by law as to the amount they can charge a Medicare beneficiary for covered services. The charge cannot be more than 120% of the Medicare fee schedule amount for physicians who do not participate in Medicare.

‡ To the extent that the blood deductible is met under one part of Medicare during the calendar year, it does not have to be met under the other part.

Source: U. S. Department of Health and Human Services, Social Security Administration.

4.4 What Medicare Does Not Cover

Services and supplies not covered by either hospital insurance or medical insurance include:

— Custodial care such as help with bathing, eating, and taking medicine.

— Most nursing home care.

— Dentures and routine dental care.

— Eyeglasses, hearing aids, and examinations to prescribe or fit them.

— Personal-comfort items such as a phone or TV in a hospital room.

— Prescription drugs and patent medicines.

— Routine physical checkups and related tests.

— Routine foot care.

4.5 Filing a Medicare Appeal

Decisions on the amount Medicare will pay on a claim, or on whether services received are covered by Medicare, may be appealed.

The notices sent from Medicare telling of the decision made on a claim will also tell exactly what appeal steps can be taken. Claimants have at least 60 days from the date they receive the notice in which to file their appeals. For more information about appeal rights claimants should call any Social Security office, the Medicare intermediary or carrier, or the peer review organization (PRO) in their states. The following is a brief summary of the different Medicare appeals processes.

4.5.1 Appealing decisions by peer review organizations

Peer review organizations (PROs) are groups of doctors in each state who are paid by the federal government to help Medicare decide when hospital care is necessary and whether such care meets standards of quality accepted by the medical profession. Medicare-participating hospitals can provide a brochure, "An Important Message From Medicare," which describes a hospital patient's appeal rights and supplies the name, address, and phone number of the PRO in that state.

If claimants disagree with the decision of a PRO, they can appeal by requesting a reconsideration. Then, if they disagree with the PRO's reconsideration decision and the amount in question is $200 or more, claimants can request a hearing by an Administrative Law Judge.

Cases involving $2,000 or more can eventually be appealed to a Federal Court.

4.5.2 Appealing all other hospital insurance (Part A) decisions

Appeals of decisions on all other services covered under Medicare hospital insurance (skilled-nursing-facility care, home health care, and hospice services) are handled by Medicare intermediaries. If claimants disagree with the intermediary's initial decision, they may request a reconsideration. The request can be submitted directly to the intermediary or through the claimant's Social Security office. If there is further disagreement with the intermediary's reconsideration decision and the amount in question is $100 or more, the claimant can request a hearing by an Administrative Law Judge. Cases involving $1,000 or more can eventually be appealed to a Federal Court.

4.5.3 Appealing decisions on medical insurance (Part B) claims

Under Medicare medical insurance, either the claimants, their doctors or their suppliers submit the claim for payment. Medicare will send the claimant an explanation of the decision of the claim on a form called "An Explanation of Medicare Benefits" (EOMB). The EOMB also explains how the claimant can appeal denials or payment decisions with which he or she disagrees, and gives the name, address, and statewide toll-free number of the carrier (the names and addresses of the carriers and areas they serve are also listed in the back of *Your Medicare Handbook*).

If a claimant disagrees with the decision on the claim, he or she can ask the carrier to review it. Claimants have up to six months from the date on the EOMB to request the review and the request must be sent to the carrier in writing.

If there is further disagreement with the carrier's written explanation of its review decision and the amount in question is $100 or more, the claimant can request a hearing by the carrier. (Other claims that have been reviewed within the previous six months can be counted towards the $100 amount.)

If there is disagreement with the carrier hearing decision and the amount in question is $500 or more, claimants are entitled to a hearing before an Administrative Law Judge. Cases involving $1,000 or more can eventually be appealed to a Federal Court.

4.5.4 Appealing decisions by health maintenance organizations and competitive medical plans

If the claimant is a member of a Medicare-certified health maintenance organization (HMO) or competitive medical plan (CMP), the same appeal rights that all other Medicare beneficiaries have apply. However, the initial steps of the grievance or appeals procedure may vary from plan to plan. Federal law requires Medicare-certified HMOs and CMPs to provide a full, written explanation of appeal rights to all members at the time of enrollment. If claimants are members of such a plan and have not received a written explanation of appeal rights, they should request one from their plan's membership office or write to: Health Care Financing Administration, Office of Prepaid Health Care, Humphrey Bldg., 200 Independence Ave., S.W., Washington, D.C. 20201.

4.6 Supplemental Health Insurance

Insurance companies offer supplemental (or MediGap) policies designed to provide coverage for amounts in excess of the amounts

covered by Medicare and for services that are excluded from Medicare coverage. By law, Medicare supplemental insurance policies must follow a uniform format and must provide certain minimum coverage. You can obtain more information about Medicare supplemental insurance policies from the state insurance commissioner's office of the relevant state. In addition, many employers offer group health insurance for retired workers that supplements the coverage provided by Medicare.

If a worker first enrolls in Medicare Part B at age 65 or older, he or she will have six months under "Medigap open enrollment period" to acquire a Medigap policy. During that period, the worker has the right to buy Medigap policy of his or her choice regardless of any health problems. The insurance company cannot refuse a person a policy or charge more than other applicants during the open enrollment period.

For workers age 65 or older who are currently employed by a firm with 20 or more employees and who accept the employer's health insurance plan, Medicare if purchased could be the secondary payer. This means the employer's plan pays first on hospital and medical expenses, and Medicare may pay secondary benefits. The worker does not need a Medigap policy, but he or she may not be able to purchase one because the Medigap open enrollment period will have expired. The employed individual would have been better off if he or she did not enroll in Part B until he or she retired.

Medicare beneficiaries can assign their Medicare benefits to an HMO or a managed care organization (MCO). HMOs and MCOs are required by law to provide all Medicare benefits. Many HMOs and MCOs also offer additional benefits, such as prescription drug coverage, to encourage enrollment. Beneficiaries who choose to assign their Medicare benefits to an HMO or MCO are, however, generally required to obtain health care services from "participating" doctors and hospitals.

4.7 Medicare + Choice MSA Plan

Effective for taxable years beginning after December 31, 1998, the Balanced Budget Act of 1997 provides that individuals who are eligible for Medicare are permitted to choose either the traditional Medicare program or a new type of plan called Medicare + Choice MSA (medical savings accounts). See the Insurance chapter, herein, for a detailed discussion of using medical savings accounts.

If the individual chooses the Medicare + Choice MSA plan, the Secretary of Health and Human Services (not the individual) makes specified contributions directly into the Medicare + Choice MSA, and the individual is not eligible for regular Medicare.

Under a Medicare + Choice MSA plan, the individual must have a high-deductible medical insurance policy (no more than $6,000 in

1999). Medicare will not pay for any medical expenses. The individual's medical expenses will be paid out of the Medicare + Choice MSA funds, plus any amount the high-deductible insurance plan pays.

4.8 Medicare Prescription Drug Benefits (Part D)

On December 8, 2003, the President signed H.R.1. the Medicare Prescription Drug Improvement and Modernization Act of 2003. This new law provides improved Medicare coverage by adding prescription drug coverage beginning in 2006. Part D prescription drug coverage will work differently from Medicare Part A and Part B. Part D coverage will not be available directly from Medicare as coverage will be with private insurers. Each plan may be a little different. The premium can be deducted from the Social Security check. Most of the drug coverage costs are paid by the federal government through private insurers.

Covered Part D drugs are drugs dispensable by prescription, biological products or insulin and corresponding medical supplies or vaccines. If a drug is otherwise covered under Part D, but paid for under Part A or B, then the drug would not be considered for Part D payment.

4.8.1 Medicare's prescription drug coverage

Effective January 1, 2007, Medicare beneficiaries are expected to pay an average of $24 monthly premiums and a $265 deductible. The actual amount will vary, as each insurance company will set its own charges and benefit packages. Some will offer a lower co-pay but charge higher premiums. Those who have drug coverage now with their employer's retiree policies can keep that coverage as long as it is as good as the basic Part D benefit which is as follows:

Annual Drug Costs	*Medicare Part D Pays*	*Patient Pays*
$ 265	0	100%
$ 266–$2,400	75%	25%
$2,401–$5,485	0	100%
$5,486 and up	95%	5%

Summary	*Annual Prescription Drug Savings*	*Out-of-Pocket Cost Plus Premium*
$1–$2,400	$1,635	$ 765
$1–$5,485	$1,635	$3,850
$1–$8,000	$4,025	$3,975

The above figures will be increased by a statutory formula annually.

4.8.2 Individuals with limited income and resources may qualify for assistance from Medicare

Starting in 2006, individuals with annual income below $14,700 for a single person or $19,800 for a couple with assets (other than a home) under $11,500 for a single person or under $23,000 for a couple can apply for assistance. Amounts will change in early 2007. Depending on the level of need:

- Premiums may be reduced or eliminated;
- Deductibles may be reduced or eliminated;
- Co-insurance and co-pay amounts may be reduced;
- Coverage gap may be eliminated.

If one lives in Alaska or Hawaii, income limits are higher.

Seniors who receive Medicaid or Supplemental Security income payments and are on Medicare will automatically qualify for additional savings, including subsidies to help pay premiums.

4.8.3 Drugs excluded from Part D plans

The following drugs are excluded from Part D by Medicare:

- Drugs used for anorexia, weight loss, or weight gain;
- Drugs used to promote fertility;
- Drugs used for cosmetic purposes or hair growth;
- Drugs used for symptomatic relief of cough and colds;
- Prescription vitamins and mineral products, except prenatal vitamins and fluoride preparations;
- Non-prescription drugs;
- Inpatient drugs;
- Barbiturates (sleeping pills);
- Benzodiazepines (central nervous system depressants).

Each Part D plan will provide its own formulary or list of covered drugs. The formulary will include both generic and brand name drugs.

5. MEDICAID

5.1 Introduction

The Medicaid program, first established by Congress in 1965, is a federal program operated at the state level to provide medical assistance to

families with aged, blind, or disabled members who cannot afford necessary medical services. The federal Health Care Financing Administration (HCFA) is responsible for the administration of the Medicaid program, but has delegated that authority to the departments of health (or equivalent agency) of the individual states. The individual states set eligibility requirements and determine the scope of Medicaid services provided within the state, provided that such requirements and services meet certain federally established minimum guidelines. Funding for the Medicaid program comes from both the federal government and the individual states.

While Medicaid benefits are available only to persons who satisfy certain need-based criteria, Medicaid has become an important resource for paying for nursing home care (even for middle-income Americans). Given that the Medicare program (discussed in section 4 above) only pays for a limited amount of nursing home care, and given the high cost of long-term nursing home care, more and more Americans must first look to individual assets, then long-term health care insurance and the Medicaid program to provide for their nursing home care needs.

Medicaid is sufficient for people who have no other means of financing nursing home care, but for those who do, it has many restrictions, such as double rooms, questionable care (particularly now that some chains are establishing Medicaid-only facilities), a small spending allowance, confiscation of income to help pay, and liens on houses of recipients. Long-term health care insurance is a much better vehicle to handle nursing home care.

5.2 Eligibility

All states must provide Medicaid benefits to persons who are "categorically needy." In addition, states may elect to provide Medicaid benefits to persons who qualify as "optional categorically needy" or "medically

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needy." Since Medicaid is state specific, and each state has slightly different rules, the state of residence rules should be examined.

5.2.1 Categorically needy

General requirements. The categorically needy generally include the following:

— Aged, blind, or disabled persons who are eligible for SSI benefits (see section 3 above)

— Individuals qualified for Medicare hospital insurance (Part A) benefits whose income does not exceed 120 percent of the federal poverty guideline and whose resources do not exceed the SSI limits

— Qualifying lower-income pregnant women and their infants

Section 209(b) states. Because the SSI program is more liberal than the assistance programs offered by several states prior to the enactment of SSI, states are allowed to elect to apply standards that are more restrictive than the SSI standards for purposes of determining eligibility for Medicaid assistance. The states making such an election (known as "Section 209(b) states") are:

Connecticut
Hawaii
Illinois
Indiana
Minnesota
Missouri
Nebraska
New Hampshire
North Dakota
Ohio
Oklahoma
Utah
Virginia

5.2.2 Optional categorically needy

The optional categorically needy generally include the following:

— Persons eligible for SSI (but who are not actually receiving benefits)

— Persons receiving optional state supplements to SSI benefits (but not receiving federal SSI benefits)

— Persons who are ineligible for SSI benefits because they reside in certain medical institutions

5.2.3 Medically needy

Spend-down states. In so-called "spend-down" states, a person is considered medically needy if his or her income (after deducting medical expenses) is below a threshold level and his or her countable resources are below a threshold level. Accordingly, a person must "spend-down" his or her income each month on medical expenses in order to qualify as medically needy for the month.

Income cap states. In so-called "income cap" states, a person is considered medically needy if such person's income is below a threshold level. If the person's income for a month exceeds the threshold, then the person is not considered medically needy even if the person's medical expenses exceed his or her income for the month.

5.3 Medicaid Benefits

For eligible recipients, Medicaid benefits generally include the following:

— Nursing home care

— Inpatient and outpatient hospital care

— Physician's services

— Laboratory and X-ray services

— Nursing services

— Home health services

— Dental services

— Prescription drugs

— Hospice services

— Physical therapy services

5.4 Resource Requirements

In order to qualify for Medicaid benefits, a person must not have "countable resources" in excess of a prescribed threshold amount.

5.4.1 Excluded resources

For Medicaid purposes, the following resources are generally excluded from the determination of eligibility:

— An individual's principal place of residence with an equity of less than $500,000 (or $750,000, if increased by the state)

— One wedding ring and one engagement ring (regardless of value)
— Items needed because of a person's physical condition (such as a wheelchair or prosthetic devices)
— Other household goods having an aggregate value of less than $2,000
— One automobile, regardless of value, if used to provide necessary transportation, or, if not so used, to the extent its current market value does not exceed $4,500
— Certain life insurance and burial insurance
— Certain business property essential to the individual's ability to support himself or herself

5.4.2 Spousal resources

For Medicaid purposes, the resources of each spouse are generally counted in determining the Medicaid eligibility of one spouse (although the income of a spouse is generally not counted in determining the eligibility of the other spouse if the other spouse enters a nursing home after September 29, 1989). For 2007, if one spouse is institutionalized, the other spouse (referred to as the "community spouse") may retain resources equal to the greater of $20,328 or one-half of the total resources of the couple up to a maximum of $101,640. The value of any resources of either spouse above that limit is deemed to be available for the support of the institutionalized spouse.

5.4.3 Transferring excess resources

In order to achieve Medicaid eligibility (especially in the case of a person in a nursing home), many clients may wish to transfer ownership of "excess resources."

> **Warning.** Practitioners must be extremely cautious when counseling clients to transfer assets in order to obtain Medicaid eligibility. As discussed below, such transfers may result in criminal sanctions against the client and any professional that counsels the client to transfer assets.

Effective February 8, 2006, the transfer of assets without adequate consideration within 60 months prior to applying for Medicaid benefits leads to a period of ineligibility for benefits for a period of months equal to the total value of the assets transferred divided by the average monthly cost for a private nursing home patient in the transferor's state of residence.

A period of ineligibility will not result, however, if the transfer was made to any of the following:

— The transferor's spouse

— The sole benefit of the transferor's spouse

— A child of the transferor under age 21

— A blind or disabled child of the transferor

— A trust that is solely for the benefit of a disabled individual under age 65

If a transfer of assets results in a period of ineligibility, however, the transferor and, arguably, any professional advising the transferor to make the transfer, may be subject to criminal sanctions. The Health Insurance Portability and Accountability Act enacted in August 1996 makes it a crime for any person to "knowingly and willfully dispose of assets (including by any transfer in trust) in order for an individual to become eligible for medical assistance under a [State Medicaid plan] if disposing of the assets results in a period of ineligibility for such assistance." While the precise scope of that provision is unclear, and has been subject to great controversy and criticism, practitioners must

(Text continued on page 39)

use extreme caution when advising clients to transfer assets if the transfer will result in a period of Medicaid ineligibility under the rules discussed above.

6. PLANNING FOR SUBSTITUTE DECISION MAKING

There are situations in which an elderly or disabled client may no longer be competent to make important decisions regarding his or her own care or the management of his or her assets. Even a young, able-bodied client may suffer an injury or disability that renders him or her incapable of making decisions. In such an event, it is important that the substitute decision maker be someone acting solely in the client's best interest. Accordingly, the professional advisor should recommend that clients consider the legal documents described below whereby they can designate the substitute decision maker in the event of incapacity. Note that the following legal documents are subject to the provisions of state law governing such documents (and that the laws of the different states vary widely) and should be prepared only by an attorney familiar with the laws of the relevant states.

6.1 Durable Power of Attorney

A durable power of attorney allows a client (the principal) to designate an attorney-in-fact to manage his or her assets and affairs. All powers of attorney terminate on the death of the principal. There are basically three kinds of power of attorney:

— **Simple power of attorney**—This document can grant limited or unlimited rights to the attorney in fact to act on behalf of the principal until the principal is incapacitated, becomes disabled, or dies.

— **Durable power of attorney**—Like the simple power of attorney, a durable power of attorney can grant limited or unlimited rights to the attorney in fact to act on behalf of the principal. The main difference is that a durable power of attorney does not terminate upon the principal becoming incapacitated or disabled.

— **Springing powers of attorney**—Like the other two types of power of attorney, a springing power of attorney can grant limited or unlimited rights to the attorney in fact to act on behalf of the

principal. The difference is that, unlike a simple power of attorney or a durable power of attorney, both of which become effective immediately upon execution, the springing power of attorney becomes effective only upon the incapacity or disability of the principal, and only remains in effect until the principal is no longer incapacitated or disabled.

A durable power of attorney generally lists broad powers that the attorney-in-fact may exercise on behalf of the grantor, such as:

— The power to manage or sell assets of the grantor
— The power to bring lawsuits, and defend against lawsuits, in the name of the grantor
— The power to deal with the grantor's pension plans, retirement benefits, and insurance policies
— The power to vote with respect to stocks and other securities owned by the grantor
— The power to make gifts of the grantor's assets

A durable power of attorney can be revoked by the client at any time (except during periods of legal incapacity).

6.2 Living Will (Advance Directive)

A living will (also known as an "advance directive") is a legal document in which the patient expresses his or her wishes to receive (or not to receive) certain artificial life-prolonging medical treatments, such as artificial feeding, mechanical breathing devices, and kidney dialysis. A living will is only effective in the event that the patient is incapable of communicating his or her present desire to the treating physician, and can be revoked or amended by the patient at any time. A living will directing that life-prolonging procedures be withheld will generally not be respected if the patient is pregnant. There are certain legal formalities that must be respected when executing a living will and, at present, not all states recognize a living will as a legally binding document. (See appendix 1, "Sample Advance Directive (Living Will)," on the *Accountant's Business Manual Toolkit CD-ROM.*)

6.3 Health Care Surrogate

A health care surrogate (medical power of attorney) is a legal document whereby a person appoints another individual to make health care decisions in the event the person is incapable of providing informed

consent. The designated surrogate is generally prohibited from consenting to treatment such as the following:

— The withholding or withdrawing of life-prolonging medical treatment (which is why it is necessary to have both a health care surrogate and a living will)
— Abortion
— Sterilization
— Electroshock therapy
— Voluntary admission to a mental health facility

A health care surrogate generally can address subjects such as:

— Whether or not the patient wishes to make anatomical gifts (organ donation).
— Whether the surrogate has the power to consent to an autopsy with respect to the patient.
— The manner in which the patient wishes to have his or her remains disposed of (burial versus cremation).

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Human Resources

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APPENDIX 2: Sample Staffing Needs Request Form (*see Toolkit CD-ROM*)

APPENDIX 3: Sample Management Questionnaire to Clarify Job Requirements (*see Toolkit CD-ROM*)

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1. RECRUITMENT

Given the expansion of laws and regulations affecting business today, companies should establish recruitment and hiring policies that are clear and concise and that take into consideration the internal environment as well as the objectives and goals of the organization. These should include procedures and guidelines that clearly identify the approach the organization intends to use in identifying the potential employees who will best meet the long-term needs of the organization.

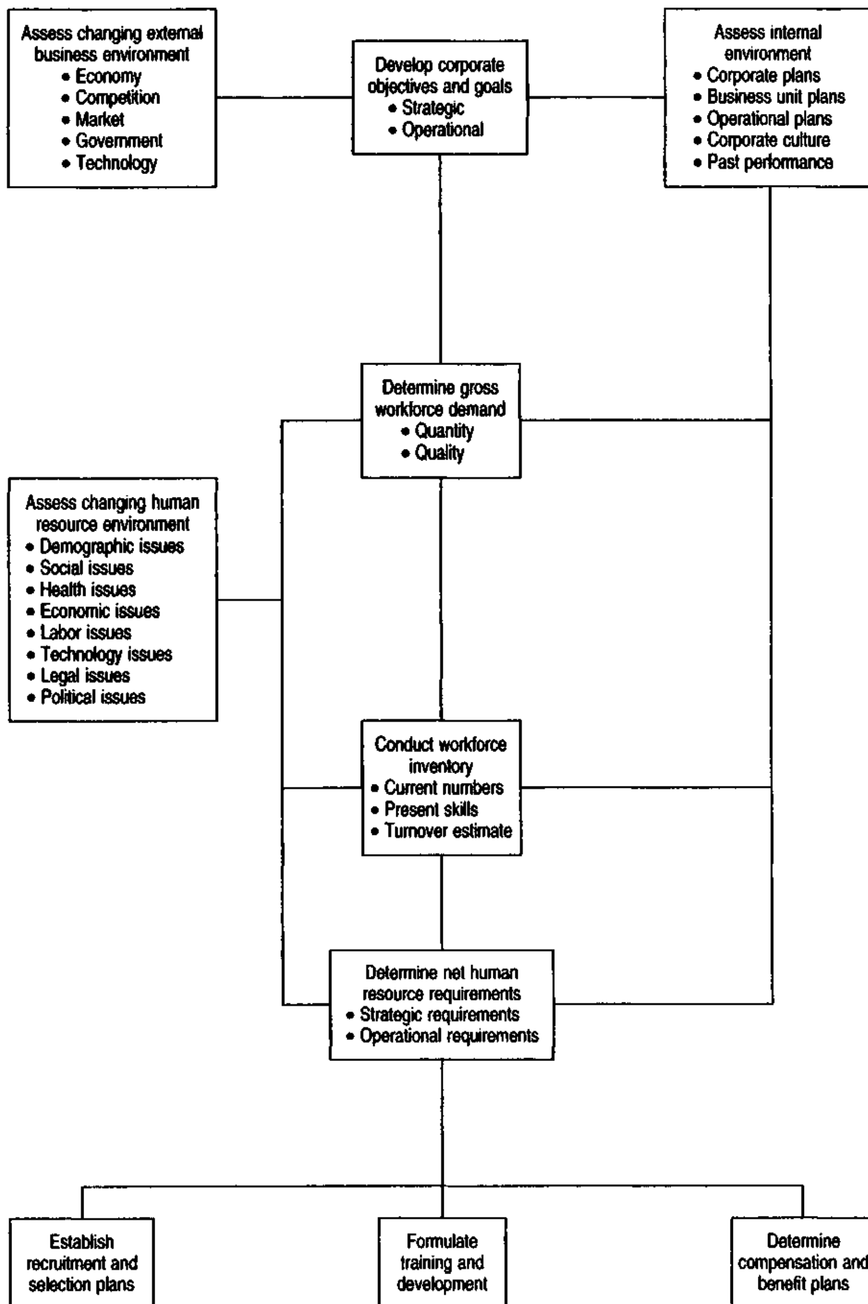
Most people would agree that planning for the firm's human resources is as important for an organization's success as is planning for its physical and financial resources. Human resource planning is a process by which a firm ensures that it has the right number of people, the right kind of people, in the right places, at the right time, doing what is economically most useful. However, if a business is to join the ranks of the most progressive organizations, it must expand beyond mere head-count planning.

Today, businesses are expected to plan, develop, and implement an integrated set of policies and programs designed to improve productivity, boost quality, and control costs, while managing diverse issues such as corporate culture and business ethics. To be fully effective, the overall business strategic plan needs to be integrated with the human resource plan. Effective human resource planning is a process that determines how the organization will move from its current to its desired human resource position as defined by its business plan and the changing environment. Exhibit 1 depicts a flowchart of human resource planning.

1.1 Policy and Objectives

If an organization recognizes people as key to its success, then the recruitment and selection of employees is likely to become the most important management function. Recruitment and selection policies and practices can make the difference between a workforce that is mediocre and one that is exemplary. That, in turn, can have a major impact on operations, growth, and profitability. The process of identifying and hiring personnel entails labor costs that add to the importance of making sure that recruitment is conducted carefully and results in the selection of quality people. Hiring costs have been skyrocketing, not only because of advertising, but also because of the time involved in campus interviewing, in-house interviewing, relocation, benefits and, most importantly, the time of the organization consumed by these activities.

Exhibit 1: Human Resource Planning



Another compelling reason to be concerned with recruitment and selection methods is the danger of employment discrimination charges. Complaints of discrimination in employment, whether justified or not, are very costly in terms of time, money, and reputation. Lawsuits can be devastating to growth and profitability. Therefore, the many pitfalls that can lead to charges of discrimination must be avoided in hiring practices.

Finally, companies today are faced with the erosion of the "employment at will principle"—the idea that employers have the right to discharge an individual at any time and for any reason. The conflict surrounding this issue is sufficient warning that the decision to hire an individual should be made with extreme caution and care, since dismissals can engender protracted and costly litigation.

The key to successful recruitment and selection practices and procedures is a clear, consistent, and well-thought-out corporate policy. A recruitment policy ensures a greater degree of uniformity in position approval and hiring practices, which is becoming more important as society becomes increasingly intolerant and suspicious of favoritism, nepotism, and other forms of personal preferences among employers.

Without a company policy, managers and supervisors act hesitantly, indecisively and sometimes with regard only to expedience. Uncertain of what the corporate policy is, they grope for answers, and the result is inconsistent recruitment practices, contradictory procedures, exposure to regulatory discipline, and threats of litigation.

A sample firm hiring policy is shown in appendix 1 (see the *Accountant's Business Manual Toolkit CD-ROM*).

1.2 Determining Needs

As stated in the AICPA management consulting service Practice Administration Aid[1] on human resource planning, seven areas should be considered before beginning the employment process:

- Identify the purpose of the position and justify its cost.
- Draft a job description detailing areas of accountability, responsibility, and specific duties.
- Evaluate the pros and cons relative to the utilization of part-time, full-time, seasonal, and potential "shared jobs."
- Consider internal promotions and transfers.
- Evaluate the labor market with an eye to future employment needs.

[1]AICPA, MCS Practice Administration Aid, *Human Resource Planning and Management for an MAS Practice.* New York: AICPA, 1991.

- Understand specifically what the company is looking for in background, skill level, qualifications, salary range, and so forth.
- Research opportunities and obligations that take advantage of federal and local programs, grants, and other legal obligations the company may have.

In larger organizations, administrators or human resource departments may require the completion of a personnel requisition form for additional or replacement staff. The form summarizes the impact on budget and organizational functioning as well as all approvals required for hiring. A sample staffing needs request form is shown in appendix 2 (see the *Accountant's Business Manual Toolkit CD-ROM*). Appendix 3 (also on the *Toolkit CD-ROM*) is a sample management questionnaire to clarify job requirements.

1.3 Development of a Job Description

Job descriptions have increased in their relative importance to an organization primarily because of the Americans with Disabilities Act (ADA), 1990, which gives their existence or absence greater weight when deciding whether an employer's decisions to hire were reasonable or discriminatory. A job description enables interviewers to understand all parameters of a job before the recruitment process begins and allows the applicants to know specifically what the responsibilities, duties, and accountabilities for a given position will be. Appendix 4 provides sample job descriptions (see the *Toolkit CD-ROM*). Appendix 27 provides a New Employee Prospect Referral Form for employees who refer prospective employees.

2. RECRUITMENT SOURCES

Once a determination has been made regarding the need for a given position, the specific criteria have been developed, and the job description is in place, the specific recruiting mechanism must take over. Inevitably, there are two resources for recruitment: internal and external.

Internally, by means of manpower and career development planning, individuals may be selected for given positions as promotions or transfers. Employers can only benefit when they allow employees to grow within their careers and capabilities. The more knowledge and skills employees possess, the greater their potential contribution. Training, combined with transfers or promotions to different responsibilities, enables employees to accumulate more knowledge so that their talents can be developed to meet the employers' needs. For this reason, many

employers identify employees with potential for promotion early on and actively encourage them to pursue advanced training. Likewise, when a job posting system is in place, employees can be notified of all job vacancies. Job openings should be announced through a variety of methods—and current employees should be adequately informed—to minimize any appearance of discrimination. In order to take advantage of the value of knowledge of "Corporate Culture," all businesses should establish an internal job posting system. This allows current, valued employees with an understanding of the company's direction and mission to become aware of job vacancies, assess their *own* skill level in response to the dictates of the job description, and make applications accordingly. Internal posting has a positive impact not only on the firm but on employees that recognize the commitment that a company is making to the growth and development of its staff.

External recruitment can take many avenues:

- Walk-ins
- Unsolicited resumes received in the mail
- Advertising in newspapers and industry publications
- Resumes received through college placement offices
- On-campus interviews
- Personal referrals
- Employment agencies and professional recruiters

Before launching a search for a suitable applicant, all unsolicited applications and resumes that have been received (as well as those of people who have been rejected for previous positions) should be reviewed. It simply is not cost-effective to start every search from scratch.

2.1 Unsolicited Applications

Often unsolicited applications are an effective and inexpensive source of potential candidates. People who apply directly often turn out to be good candidates. They probably applied because the company is conveniently located or is in an industry in which they have experience. They may have heard of the company or have familiarized themselves with it. Many firms meet the majority of their workforce needs in this way. At the very least, receipt of the resume or application should be acknowledged, as a matter of courtesy; in most cases, a follow-up letter should be sent.

2.2 Print Advertisements

When it is necessary to extend a search for candidates, the most common method is to place a newspaper advertisement. Recruitment ads should be viewed as part of the company's overall effort to sell a job to prospective employees. The aim of this ad, as with an entire recruitment program, is not to attract the largest number of applicants, but to attract the most qualified applicants. The ideal candidate should want to answer the ad as soon as possible.

Where advertisements are published affects the time and money spent in recruiting. The key is not to select publications with the largest readership, but ones that are most likely to be read by the kinds of applicants being sought.

Newspapers' help wanted sections are read by nearly everyone who is looking for a position. A newspaper ad is easy to place, and often appears within days of its submission. Ads in trade and professional journals are usually cost-effective, since they are normally read by people with precisely the qualifications for those trades or professions. The problem is that many of these publications are published infrequently, monthly at best, and have long lead times. Thus, it can take weeks and even months for an ad to appear and for suitable candidates to respond.

2.3 Open Houses

When a company is seeking to employ several individuals in the same job category, or planning a rapid expansion into a new service area or locale for which it may be considering a substantial number of people, it may want to consider the feasibility of holding an open house. This is a cost-effective way of screening a large number of applicants over a one- to two-day period. It is also a good way to get managers and supervisors to meet large numbers of prospective employees and to discuss the vacancies with them personally. For the potential employees, an open house can serve to introduce them to the company and its staff and effect some self-selection among applicants.

2.4 Job Fairs

Though similar to an open house mentioned earlier, this involves many companies located within a geographical area. By exhibiting at job fairs, a company can learn whether or not its salaries are competitive, and about employment trends and changes in the labor market. Participation in a job fair is normally very cost-effective since advertising and rental costs for the site are shared with other employers. The major cost is the expenditure of time.

2.5 Campus Recruiting

It is useful to maintain an ongoing relationship with administrators, faculty members, and counselors at local schools, colleges, and universities. This kind of recruitment offers many advantages over the other techniques. One significant advantage is that people are recruited with recent state-of-the-art knowledge. New graduates can often make significant contributions because of their enthusiasm. College students are particularly interested in getting their careers off to a good start and they normally want to work for a good company. For them, this generally means one with growth potential, opportunities for advancement and personal development, and a good reputation in the community. See Hiring Foreign Nationals section 2.3.5 for employment options for F-1 foreign students and section 2.3.6 for H-1B eligibility for work authorization for foreign students who qualify for a professional position.

2.6 Employment Agencies

Many employment agencies are part of a nationwide recruiting network. These agencies have the capability to recruit from outside the immediate labor market area. This is particularly important if you are trying to fill positions that require special skills and talents that are not easily available locally. Fees of employment agencies, particularly for key, highly paid personnel, can be high. Agencies usually charge a fee of anywhere from 10 percent to 15 percent of the placed applicant's annual salary, with some fees as high as 30 percent.

3. INTERVIEWING

How many people need to be interviewed to fill a job opening? Ideally, one—if that person meets all the job requirements. It is not true—although many people believe otherwise—that the greater the number of applicants interviewed, the better the chance of finding the ideal employee. One person with the right qualifications is all it takes. And the best interview candidates can be identified before any meetings take place, through an effective screening process.

3.1 The Process of Elimination

3.1.1 Related skills

Although it may be important to be critical in evaluating resumes and other applicant information, it is also necessary to be able to recognize the transferability of skills and abilities. The failure to do the latter may

result in bypassing individuals who lack exactly the ideal experience or education, but who nevertheless have excellent capabilities. Applicants with less experience than desired in a certain field may have other qualities that could prove suitable for the job.

3.1.2 Basic qualifications

The resumes or job applications received should indicate which individuals are sufficiently qualified to be given further consideration. The first step is to check for the *minimum* requirements that have been established for the job. These may include minimum skills, basic levels of education, or the same or related experience. Only those applicants having at least these basic qualifications should be considered. This screening process prevents wasted time spent interviewing unsuitable applicants.

3.1.3 Work experience

The best way to evaluate work experience is to design a checklist of job specifications and duties and compare the applicants' experience against the established job criteria. The more experience an applicant has in a greater number of specified areas, the better prospect he or she may be.

The applicant's job history, including the frequency of job change, should be used to evaluate growth, development, and achievement over a period of time. There is substantial evidence that an individual's employment history is a major predictor of tenure—how long an individual will remain with the company. These factors should all be used to rate the applicant in terms of related work experience.

3.1.4 Education

An applicant's academic, vocational, or professional education should be examined in terms of how it relates to a job's requirements. First, check the degree earned, if any, and the major area of study, and determine whether they are relevant to the job. In many cases, an applicant's educational background will help to assess not only a candidate's ability to perform a job, but his or her intellectual ability to cope with difficult situations or to prioritize a number of different kinds of assignments. Educational background should have more importance for jobs that require specialized knowledge or for applicants with little or no related work experience.

3.1.5 Personal characteristics

When screening applicants who are still good prospects at this stage, look for factors that are potentially significant indicators of success in

the job, such as personality, motivation, and interests. Consider the amount of independent action and judgment required, the pressures of the job, and the future potential of the job and the employee. There may be, as well, long-term consideration of the applicant's potential for future promotion.

3.1.6 The application itself

The appearance of the resume or application says something about the applicant.

— Is the resume or application neat and legible?

— Is the information presented well?

— Are there inconsistencies or contradictions?

Observe whether there are any omissions in the application, or questions that have been left unanswered. Although an applicant should not be rejected because of failure to answer a question, it should be noted that if the applicant is invited to interview, these gaps should be filled in. A sample application is found in appendix 5 (see *Toolkit CD-ROM*).

3.2 Preparing for the Interview

There are five major steps in preparing for interviews, and each plays a critical role in the selection process.

3.2.1 Know the job

The most important part of preparing for an interview is to know the job. The interviewer should carefully review the job description to understand the job to be filled and the qualifications it requires. The interviewer needs to review the job duty specifics and know how the job fits into the specific function or department of the organization. The interviewer will also need to know relevant information, such as travel and overtime requirements, opportunities for promotion, and working conditions.

3.2.2 Determine the objective of the interview

Although the general purpose of interviewing is to select a candidate for a position, each particular interview should have a specific objective. Screening interviews are intended to select potential candidates for further consideration. Once several good candidates have been selected, the objective of the next interview may be to determine the best-qualified candidates. In this instance, individuals are judged against each other in an attempt to establish which ones have overall superiority.

In a number of circumstances, individuals may be interviewed to determine whether they have potential for later hiring.

3.2.3 Plan the format

Planning is an important part of preparing to interview. Things to be determined in advance include:

- — The number of interviews to be conducted and by whom before making the final decision
- — The approximate time allotment for each interview
- — The specific issues to be covered

Included in appendix 6 (see the *Accountant's Business Manual Toolkit CD-ROM*) is a sample form for listing interview questions. Maintaining a standard set of core questions and topics ensures that all important job-related issues will be covered in the interview and establishes a uniform set of topics on which an array of candidates' responses can be judged.

Additionally, the *Accountant's Business Manual Toolkit CD-ROM* contains two more forms for interviews. Appendix 7 contains an extensive set of sample questions which can be used during the interview process. Appendix 8 contains a list of questions that are inappropriate to ask during an interview or on an application. Adding such questions may be discriminatory if not directly job-related, as rejected candidates could contend they were turned down due to their race, sex, age, religion, or non-affective disabilities. If desired, questions from appendix 7 can be used in conjunction with appendix 8 in designing a standard set of interview questions.

3.2.4 Learn about the applicant in advance

An essential part of the interview strategy is for the interviewer to carefully review in advance each candidate's job application or resume. This practice precludes using interview time to ask for information that has already been provided, as well as giving the interviewer a chance to get acquainted with the applicant before the meeting. The application form or resume provides some clues about the candidate. Specific questions to be asked by the interviewer may be based on aspects of the person's background.

3.2.5 Provide for privacy

Make sure that there will be no interruptions during an interview. Arrange for privacy. If a private office is not available, reserve a conference room. Inform the receptionist that there are to be no telephone

calls, messages, or other interruptions during the interview. Intrusions can distract attention and destroy the momentum of an interview.

In order to establish a controlled, objective evaluation procedure, it is useful to prepare an interview report following each candidate's interview. The report helps to standardize evaluation criteria so that, regardless of each candidate's personal differences in expression, experience, and bearing, the interviewer can characterize responses in standardized terms to permit comparative evaluation. Appendix 9 (see the *Accountant's Business Manual Toolkit CD-ROM*) shows a sample interview rating report, and interviewer's and interview evaluation forms. Immediately following an interview a numerical rating of suitability can be calculated for comparison with other candidates. Appendix 26 (see the *Accountant's Business Manual Toolkit CD-ROM*) contains a form to document and schedule contacts to be made with the candidate.

4. REFERENCE CHECKING AND TESTING

4.1 References

Due to the legal ramifications of the release of information received from a reference check, all employers are cautioned to check with applicable state statutes, which vary widely. A number of states restrict employers from releasing information without written authorization from the applicant.

Because most companies are reluctant to give any information other than name, dates of employment, and positions held, it is advantageous for all employers to have a *consent to release employment information* form prepared for all employees to sign when they leave the organization. Likewise, you may wish to develop a form to include in the interviewing packet that all applicants will sign, which is a release of information to you from the respective applicant's prior employers. Appendix 10 is a form to use in collecting telephone reference check information (see the *Accountant's Business Manual Toolkit CD-ROM*).

4.2 Testing

After reviewing all the information contained on an application or resume, having conducted the interview itself, and having performed any reference checking that was feasible, an employer may also choose to test candidates for their ability to perform certain key job duties.

Some standardized ability tests measure the candidate's relative skill levels in typing, keyboarding, and calculating. Employers can themselves

devise tests of particular specific job skills, such as written communication, logical problem solving, proofreading, or aptitude for specific complex tasks. These measure how well an individual may perform an activity on the job.

A second kind of test is called a "screening test." Screening tests include those for drug and alcohol abuse, polygraph or written integrity or honesty tests, and medical examinations. The administration of any of these tests entails a legal concern about whether negative results are attributable to race, sex, nationality, religious affiliation, age, or disability.

It should be noted that under the new ADA, businesses employing fifteen or more persons can ask medical questions or require a medical examination of job candidates only after a conditional job offer has been made.

It should be noted that although personality tests, aptitude tests, drug tests, and so forth, are still prevalent in the employment process, studies indicate that their use is waning.

5. COMMUNICATION WITH APPLICANTS

5.1 Job Offers

Candidates should be notified whether or not they have been selected for a position within a week or two of having been interviewed. A person is either right or wrong for a job, and procrastination in the decision-making process is counterproductive. There is no reason to think that a better candidate will appear next week; that other person almost never materializes, and in the meantime, a good candidate who has been kept waiting may no longer be available.

When a decision is made to hire an individual, one person within the firm should be designated to respond with a job offer. Job offers are usually made verbally, followed by a letter of confirmation stating the starting date and salary agreed upon by the firm and the candidate. Appendix 11 (see the *Accountant's Business Manual Toolkit CD-ROM*) contains a sample job offer letter. Appendix 28 (see the *Accountant's Business Manual Toolkit CD-ROM*) contains a Sample Employment Agreement, that when properly drafted, can set the ground rules for any new employment relationship.

It is wise to set up a special file for all application forms from applicants who were rejected for employment. This should include not only the application forms, but a record of all correspondence between the company and the applicants and all reputable telephone contacts.

If, at some future date, the firm is called upon to explain why a certain candidate was not hired, these records will provide all the necessary information. For *every* new employee, an employer must verify both the employee's identity and work authorization by filling out Form I-9. See Hiring Foreign Nationals section 7.1 for instructions on completing Form I-9.

(Text continued on page 17)

5.2 Informing Rejected Applicants

As soon as applicants are no longer under consideration, they should be informed. If a candidate is interviewed and immediately eliminated from consideration, a letter should be sent out the next day. Appendix 11 on the *Accountant's Business Manual Toolkit CD-ROM* contains a sample rejection letter.

Every individual who has been interviewed should receive a response. Not to do so is unprofessional and creates a poor image. People who receive no response will communicate this to their friends and other potential employees.

5.3 Responding to and Retaining Applications and Resumes

All businesses who have an image to maintain in the community should respond to all requests for employment—be these walk-in candidates, telephone inquiries, or unsolicited resumes. A firm should preserve a good positive image in the event that these candidates become viable at the time of the next vacancy.

Retain potentially viable resumes and applications. As stated earlier, the second step in any recruitment process, once needs have been defined, is to review all the resumes and applications that are on file. This pool of potential candidates can reduce additional costs in advertising and preliminary screening.

6. NEW EMPLOYEE ORIENTATION

In order for the employee and the company to start out well together, it is imperative that a proper orientation program be established. Specific objectives of this program should be—

- Making the employee comfortable in the new work environment.
- Developing and maintaining a positive attitude on the part of the employee toward the organization, the supervisor, and the job.
- Making the employee productive in terms of quantity, quality, safety, and dependability.
- Developing an employee who will be a team player as well as an individual performer.
- Enabling the employee to work independent of close supervision as soon as possible.

In order to accomplish the preceding objectives, good communication will be required from the first day of employment. Employees will obviously need to learn more about the employer than can be communicated in an interview. They will need to know how to "sense the environment" and become aware of the political pitfalls that impact all organizations. Much is being written about "coaching" or "mentoring." It is a time-tested way to ensure that all new employees are trained in the culture of the organization as well as in the technical aspects of the job. According to the AICPA's *Management of an Accounting Practice Handbook*, "The firm is the biggest winner in a mentoring program." Three parties are involved in any such program—the protege, the mentor, and the firm. While all parties grow, the firm benefits in very tangible ways.

It is essential that an organization have a checklist specifically designed to cover the necessary aspects that all new employees will be expected to learn. Appendix 13 (see the *Accountant's Business Manual Toolkit CD-ROM*) contains a sample orientation checklist.

Appendix 12, "Sample Employee Personal Information Update," on the *Accountant's Business Manual Toolkit CD-ROM*, illustrates a form that can be used at a later time to update personal information of the employee originally obtained at the time of employee orientation. See Appendix 24, "Sample Employee Handbook," and Appendix 25, "Sample Employee Code of Conduct," on the *Accountant's Business Manual Toolkit CD-ROM* for illustrative examples of materials that can be updated on an annual basis.

7. EMPLOYEE DEVELOPMENT AND PROMOTION

7.1 Systems Design

The entire human resources (HR) process is designed to ensure that an organization attracts, retains, and develops talented employees who will accomplish the mission of the organization. Accordingly, it must be a comprehensive system that is integrated and clearly laid out. There should be a clear linkage and interdependency between individual work plans, performance evaluations, job expectations, promotions, salary adjustments, and the overall operating budget of the organization. The elements of this process should be placed on a specific timetable, building in not only the required due date, but also the lead times that are necessary to support the process. For example, if performance evaluations are scheduled for July 1, written evaluations from supervisors may need to be received no later than June 15 and supervisors may need to receive the paperwork to prepare written evaluations no later than June 1.

The overall HR process must also relate directly to the financial budget. Management will have a difficult time approving salary adjustments without knowing the effect it has on the budget. Likewise, management and employees need to have a clear definition of what a promotion means. Depending on how these issues interrelate, a promotion could mean simply a title change, a salary adjustment, or an actual shift in responsibilities. See Appendix 15 on the *Toolkit CD-ROM* for a chart describing the dependency of HR issues on the budget process.

7.2 Individual Work Plans

While written job descriptions (see section 1.3) may describe the general and even specific expectations and tasks for a position, they may not effectively motivate employees to achieve individual excellence in their job. Job descriptions that are designed around a collection of "tasks" might encourage employees to focus on becoming task-masters rather than pursuing the higher mission of the organization. This concept can be illustrated by employees who believe they should be promoted because they can document how they have completed every task on a job description, even though they may be unpromotable because they lack the vision to deal with the big-picture issues.

Consider having supervisors work with employees to develop individualized annual work plans that will challenge and reward them for making improvements in their job performance. An individualized work plan might include such specific goals as a percentage increase in efficiency or realization over the previous year, a specific number of new proposals presented, or a certain number of marketing calls made. The work plan may also include less quantifiable goals, such as increasing knowledge and education in a specific business niche. When creating their own annual work plans with input and guidance from supervisors, employees have an ownership stake in improving themselves and the organization. It is the supervisor's job to ensure that the work plan is aligned with the overall mission of the organization. Employees should clearly understand how their compensation relates to achieving both the spirit and specifics of the work plan goals. See appendix 16 on the *Toolkit CD-ROM* for an example of an annual employee work plan in a service organization.

7.3 Continuing Education

A training plan should be developed for each staff person to maximize the training opportunity of job assignments. Experienced personnel

should be evaluated on their effectiveness in training and developing subordinates so that the subordinates gain appropriate experience.

7.3.1 On-the-job training

One of the most effective mechanisms of providing on-the-job training is through feedback on work completed. Reviewer comments and personal evaluation sessions allow a less experienced staff to learn from experienced staff as they take on more complex tasks. Although the tendency of many experienced technicians is often to "fix it myself," on-the-job training and successful staff development occur only through adequate feedback. One-on-one review of work and constructive evaluation also help develop good personal communication skills. The ability to express and accept differing points of view is essential to building solid business relationships with clients and customers. Even though on-the-job training is very important in attaining and maintaining competence, this type of informal learning would not qualify for accredited continuing education (CE).

7.3.2 Continuing education providers

Continuing education courses are offered by numerous private providers and by industry trade associations. Most private providers announce courses through direct marketing techniques such as the Internet and direct mail, as well as in professional journals and at professional meetings, conferences, and conventions.

Employers who value lifelong learning understand that CE requires a significant time and financial investment. Because of this, it is important to adequately plan and evaluate CE sessions. Appendix 17 on the *Toolkit CD-ROM* illustrates a sample form for staff evaluation of CE courses. The participant gives the course an overall rating and rates the subject matter and instructor (if applicable). The participant also details new concepts learned, and recommends whether others should attend. Course evaluations should be as thorough as possible and they should be retained for a period of time. Employers should specifically track and keep records of these sessions by individual, to assure that everyone receives adequate training in required areas, and to provide information for CE reporting requirements. In addition, tracking and evaluating CE sessions eliminates redundancy in attendance, and allows better selection and planning for CE courses in the following year.

7.4 Performance Review Process

Each employee has a right to know how he or she is performing. Ongoing communication is essential to give constant feedback in

addressing performance concerns and acknowledging superior effort or results. This is important not only at the time of salary or promotion determination, but also at the time of the potential discharge of an employee. All performance evaluations should be documented, dated, and signed by the employee and respective supervisor. Appendix 18, "Sample Professional Development Appraisal," on the *Toolkit CD-ROM*, is a sample form designed to document and assist in the evaluation and career planning process.

The entire process for evaluating, promoting, adjusting salary, and establishing goals should be scheduled in advance to ensure its timely completion. The process begins by assigning team members to complete written evaluations. Multiple perspectives on an employee's performance will ensure that individual bias or paradigms do not distort the evaluation. If multiple evaluations are completed for each person, one concise report may summarize the information and maintain anonymity of the evaluators if desired. Written evaluations provide a basis for evaluating employees for promotion and preliminary salary increases.

Management may wish to approve promotions before meeting with the employee. The performance evaluation meeting may then be used to communicate the promotion or obtain additional feedback from the employee prior to finalizing promotion decisions. The evaluation meeting is also an opportunity to set annual work plan goals for the coming year. With the wealth of information derived from the evaluation process and the promotion decisions, employees can be better evaluated against their peer group and marketplace for compensation. See appendix 19 on the *Toolkit CD-ROM* for a flowchart and timeline describing the review process.

8. COMPENSATION

8.1 Compensation Objectives

The fundamental objective of a salary administration plan is to ensure that employees are paid in relation to the value of the work they perform. The company should receive a fair return on its salary investments and, in turn, individual employees should receive a fair compensation for their abilities and efforts.

The specific objectives of any plan should be—

- To pay competitive salaries as an attraction to superior people and motivation for them to do their best.

- To establish and maintain a logical, consistent scheme of value relationships among positions that represent an objective analysis of the division of responsibility.
- To pay individuals fairly according to their relative contribution to the effectiveness of operations, the objective measurement of which is considered to be the relative value of the work each individual performs and the results achieved.
- To establish and maintain a competitive, sound salary structure—one that provides strong inducement to individuals to advance and to assume greater responsibilities.
- To establish and maintain salary ranges for the respective salary grades that afford ample latitude for recognizing and rewarding performance improvement and superior performance.
- To establish and maintain logical earnings relationships between supervisors and their subordinates.
- To maintain a competitive compensation structure that is applied subject to various economic pressures such as inflation, salaries at other companies, and the profitability of the organization.
- To establish meaningful differentials in compensation between individuals performing at significantly different levels and administer adjustments so as to recognize these differentials.
- To comply fully with provisions of all government regulations regarding compensation.
- To plan and implement all compensation expenditures through the budget system.
- To communicate to all employees the compensation policy and the methods of administering this policy.

8.2 Job Analysis—Job Descriptions

The advantage of having carefully prepared, properly used job descriptions should be obvious to anyone in the management field. But because so many organizations have not prepared and used their job descriptions properly, many of these benefits have been lost or overlooked. Consider the following:

1. Job descriptions clarify who is responsible for what within the organization. They also help define relationships between individuals and between departments. When used to advantage, they can settle grievances, nip conflicts in the bud, and improve communications.

2. Job descriptions help the jobholder understand the responsibilities of the position. This not only enables the employee to assess the relative importance of everything he or she is accountable for, but also provides a sense of where the job fits into the larger responsibilities of the organization as a whole.
3. Job descriptions are helpful to job applicants, to employees, to supervisors, and to human resources staff at every stage in the employment relationship, from recruitment to retirement. They provide information about the knowledge, training, education, and skills needed for each job. They prevent unnecessary misunderstandings about responsibilities and duties. They can guide both a new employee who may have forgotten or misunderstood some aspects of the job, and a supervisor who may think the new hire does not fully understand the job. Best of all, they provide this information in a completely objective and impersonal manner.
4. Job descriptions help management analyze and improve the organization's structure. They reveal whether all company responsibilities are adequately covered and where these responsibilities should be reallocated to achieve a better balance.
5. Accurate job descriptions provide a basis for job evaluation, wage and salary surveys, and an equitable wage and salary structure. (Job descriptions can be used to either support or discredit comparable worth and other job description complaints, and for this reason they should reflect only the truth about the job in question.)

Despite these and many other potential benefits, job descriptions have traditionally suffered a poor reputation among managers and supervisors. In fact, even companies that have spent a great deal of time and money preparing job descriptions often end up ignoring or underutilizing them. Exhibit 2 depicts uses of the position descriptions.

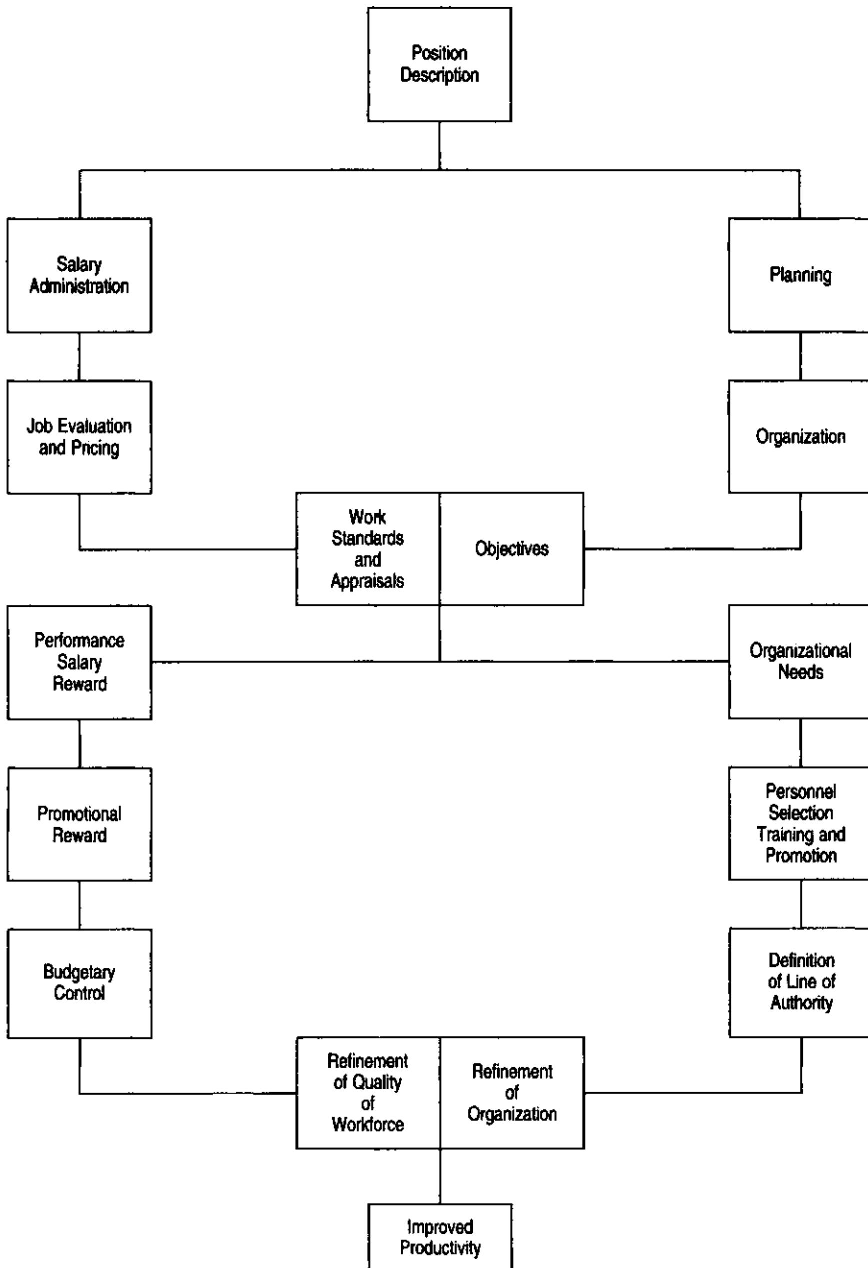
8.2.1 How are job descriptions used

One of the reasons that so many organizations have job descriptions that are not used is that they are simply unaware of their many uses. Many employers think of job descriptions only in terms of wage and salary administration, or as a necessary evil in complying with certain employment laws. But these are only two of the many practical uses for job descriptions, most of which can be grouped under the following four headings.

1. **Personnel Administration.** There is probably no better tool when it comes to human resource planning than a well-written set of job descriptions. Consider their usefulness in the following areas:

— Responsibility planning

Exhibit 2: Use of the Position Description



— Recruitment and screening

— Hiring and replacement

— Orientation

— Training and development

— Career ladders

2. **Wage and Salary Administration.** Any compensation system requires that jobs be classified and evaluated in terms that make comparisons possible. This is where good job descriptions come in. They are especially valuable in the following compensation-related activities:

— Job evaluation

— Job classification

— Wage and salary surveys

— Pay structure

— Performance appraisal

3. **Legal Guidance.** Changes in employment legislation have been frequent in recent years, and new issues—such as comparable worth—are always being tested in the courts. Job descriptions are important in complying with a number of the major pieces of government legislation, including the following:

— Fair Labor Standards Act

— Equal Pay Act

— Title VII of the Civil Rights Act of 1964

— Occupational Safety and Health Act

— Age Discrimination in Employment Act

— Employment Security Act

4. **Collective Bargaining.** The issue of varying pay rates for similar work has often been raised by unions, who may point to job descriptions as a basis for standardizing these pay rates. Job descriptions have also been used by employers to defend themselves against what they believe are unjustified union demands for uniform rates. Good job descriptions can clarify which jobs are truly similar, and which jobs warrant different pay levels because they require different levels of skill, knowledge, or responsibility, or because they contribute to the organization goals in different ways.

8.2.2 Responsibility planning

Actually, the process of preparing job descriptions serves a useful purpose in itself, particularly if it starts at the upper levels of the organizational hierarchy. The preliminary drafts of managerial and executive job descriptions can be used as a basis for productive group discussion in which managers and executives get together to talk about each other's responsibilities. Such discussions often reveal areas in which overlapping responsibilities or confusion about the limits of responsibility are a problem, or where the organizational structure is faulty. When these problems have been solved, each manager can then repeat the process with his or her own subordinates in reviewing and discussing their job descriptions. A side benefit of this approach is that managers and supervisors are more likely to feel committed to supporting a system that they have helped to create. They are also more likely to use job descriptions for a number of the purposes outlined above, rather than letting them collect dust in a drawer.

Other uses for job descriptions are the following:

— Job posting

— Management by objective programs

— Grievance procedures

— Work flow analysis

— Organizational studies

See Appendix 14 (also see the *Toolkit CD-ROM*) for job description preparation forms.

8.3 Job Evaluation

By definition, job evaluation is the consistent, logical, and equitable analysis and measurement of job responsibilities and duties. The emphasis is put on the *job* since the focus is on duties and responsibilities relative to the firm's goals—*not* on the employees currently holding the job.

The objectives of job evaluation are to—

— Eliminate or decrease wage and salary inequities.

— Provide accurate data for hiring new employees.

— Assist supervisors in determining which employees qualify for promotion.

— Determine whether employees are qualified for their current jobs.

— Help train supervisors to counsel employees in order to improve job performance.

To properly introduce a job evaluation program, it is important that the details and objectives be communicated first to the managerial and supervisory group and then to the employees whose positions will be evaluated. This communication should be written and should carry the endorsement of top management.

There are various kinds of evaluation plans or systems in use in industry today. The most popular plan is termed "the point factor technique." For the sake of brevity, this chapter only comments on the following three predominant evaluation techniques:

— Point factor

— Factor comparison

— Ranking

The point factor evaluation is based on well-defined factors or so-called common denominators that apply to the group of jobs being evaluated. The factor of education, for example, is important in determining job worth for any position. Education, as it is commonly used in job evaluation, measures the trade-training or formal knowledge (in terms of years of education) required to perform the job duties under normal supervision. This may have been acquired by education, by outside study, or by training received on jobs of lesser rank. Under this factor are varying degrees, numerically cited, that indicate the levels of education required. Under the point factor plan, when a job is rated on education, a specific numerical score is applied to indicate the required job education. The same procedure is followed in reviewing other factors required by the job as rated.

The factor comparison evaluation technique compares jobs by making judgments concerning which jobs contain more of certain appropriate factors than others. Jobs are compared to one another, one factor at a time. In one such factor comparison plan, certain *universal factors* are used: mental requirements, physical requirements, skill requirements, responsibility, and working conditions. This technique is similar to that of point factor, except that no numerical scores are used. This may prove to be a potential disadvantage because more guesswork is involved.

The third evaluation technique used is that of ranking. Under this technique, jobs are ranked without regard either to factors or to point values. Usually, the determination of job rank is based on its worth to the organization. To assist an organization wishing to rank its jobs, key or benchmark jobs are first ranked. These key jobs are ones that are common throughout industry and are more readily understood by the members involved—jobs, such as janitor, punch-press operator, or clerk/typist.

8.3.1 Internal equity

The objectives of establishing a pay structure are to maintain competitive rates of pay and to maintain differentials between jobs within the organization. This ladder is often called internal equity.

Job evaluation, which has already been discussed, has as its objective the establishment of proper job differentials. The next step then is to analyze and apply competitive pay rates to these jobs—referred to as external competitiveness.

8.3.2 External competitiveness

The approach usually taken is to make a wage or salary survey of the organization's industry and area of operation by benchmark jobs. Benchmark jobs are those that are similar enough in content to allow similar industry comparisons. In making a survey of this kind, it is very important that the comparison be made not on the basis of job title alone, but on careful consideration of job responsibilities as well.

There are many wage and salary surveys available. Employers' associations, chambers of commerce, trade associations, and consulting organizations make such surveys on a periodic basis.

Once an external comparison is completed and compared to the worth in which the evaluation measured the internal equity, a salary range can be developed.

8.4 Salary Ranges

A salary range is established to allow an individual room for growth within a job classification based on job performance over the years. Each individual range moves on an annual basis. Employee performance should be evaluated to be consistent with the company's ability to pay an appropriate salary that is commensurate with performance and that moves the individual up the salary range of the position. The ultimate goal is to ensure that a solid, competent performer is maintained at or near the average (midpoint) of a salary range that is both internally equitable and externally competitive.

8.5 Performance Reviews

The need for emphasis on performance appraisals has already been discussed. Performance appraisals serve more day-to-day purposes outside the human resources function than is generally recognized. For purposes of compensation, the performance appraisal system should help employees and managers set goals for themselves and for the

organization. Goals should be measurable and should be reassessed throughout the year, as summarized in the following sections.

8.5.1 Setting goals with subordinates

Identify goals that are commonly set within the organizational unit for the upcoming budget period. Such goals often relate to profitability, competitive position, and productivity. In addition, the goals can be educational devices to encourage and promote staff development in the following areas:

— Technological leadership

— Employee development

— Public responsibility

— Employee relations

Working organization charts should be prepared that illustrate titles, duties, relationships, and impending changes. As objectives are set for the next budget year with each person, the following should be completed:

— Subordinates should be asked to make notes on their objectives for the coming year. These objectives should cover routine duties, problem-solving goals, creative goals, and personal goals.

— Lists should be prepared of the objectives that subordinates should include, noting innovations and improvements that are needed in each function.

— In personal conferences, subordinates' objectives should be reviewed in detail, and suggestions or changes should be offered.

— Three copies of the employees' objectives should be prepared: one for the employee, one for the firm's records, one for the supervisor.

— Working from the final document, supervisors should ask what they can do to help employees accomplish their goals. Suggestions should be kept with the supervisor's copy of the goals, becoming part of the supervisor's goals.

During the year, each subordinate's goals should be checked as promised milestones are reached.

— Is the employee meeting targets?

— Should the targets be amended?

— Is the supervisor helping the subordinate?

— Use jointly agreed upon goals as tools for coaching, developing, and improving the subordinate's performance on a continuous basis. Reenforce good results by feedback of success.

8.5.2 Measure results against goals

— Near the end of a budget year, subordinates should be asked to prepare a brief statement of performance against budget using their copies of the performance budget as a guide, supplying relevant figures where applicable. Individuals should give reasons for variances and list additional accomplishments not budgeted for.

— A date should be set to go over reports in detail with subordinates.

— The evaluator and subordinate should reach agreement on just how good job performance was, and where improvement should be made.

— Other concerns may be covered at this time—job, opportunity, job-related personal problems.

— Following evaluation, the stage is set for establishing the performance budget for the next year.

8.6 Merit Guides

Since the fundamental concept of the salary program is that individual pay should be based on progress and performance improvement, the performance evaluation becomes a salary recommendation or discussion. Certainly for this philosophy to be meaningful, the individual salary decisions must be appropriately related to judgments about employee performance results. The responsibility for successful achievement of this key relationship, both in actuality and as perceived by employees, rests with the immediate supervisor.

Once an employee's performance results have been measured, the next step is to select the appropriate merit treatment for that person. To assist the supervisor in this decision, a set of percentage and frequency guides should be established for each job classification. The term *guide* is used to distinguish these from rules. The indicated percentages and frequencies are intended to provide a guide for management discretion, not to establish rules within which supervisors must operate. Guides are never the reason for giving or not giving an increase.

Increase guides cannot be effectively applied simply on the basis of performance and the position of the current salary in the range. One additional piece of information is needed—the employee's rate

of performance progress. This factor is important in determining when an increase should be given.

The appropriate use of any guide links performance judgments to individual salary progression. The progression through the salary range should be emphasized as a rate, and the individual's position in the salary range should depend on performance.

Those employees who consistently far exceed performance expectations progress to the upper portions of their salary range, while employees who make steady performance improvement generally retain their position within their salary range. According to this philosophy, it is necessary for the supervisor to determine each employee's performance relative to their peers in addition to their performance results against the established job standard and agreed-upon objectives. These two ingredients will determine precisely the position in the salary range to which an employee will progress and how long it will take the employee to get there. Individual salary increase decisions made by the employee's supervisor will reflect that result.

9. BENEFIT PROGRAMS

9.1 Objectives of a Benefits Plan

Employees provide valuable skills and knowledge that are essential to help a firm grow and prosper. For that work, employees are compensated not only with salary but also with a total benefits program.

The objective of a total benefits program should be able to give employees and their families three things:

1. Protection in time of financial need
2. Security to help them build their personal savings
3. An opportunity to grow in their careers and enjoy a richer life while they are away from their jobs

9.2 What You Can Afford

All payments made to employees for time not worked, along with additions to pay for the employees' benefit, are termed "benefits" or "fringe benefits." In the past, these benefits accounted for only a small part of total compensation—less than 5 percent. In recent years, benefits have become a popular means of attracting and retaining good workers. This development, along with the increase in collective bargaining activity and the advantageous treatment given to benefits under federal tax

laws, has gradually given rise to an employment picture in which certain benefits are now almost universally taken for granted. Benefit costs now account for more than one-third of payroll outlays.

There are many misconceptions in the marketplace today relative to what companies must provide by way of benefits to its employees. Social Security and Medicare payments, unemployment insurance, and workers' compensation (mandated by the individual states), serve as the only required benefits. Recent legislation relative to the American with Disabilities Act and the Family Medical Leave Act stipulates certain policies relative to the granting of time off for employees, but since these are leaves "without pay," they are not considered benefits.

There are basically three types of cost considerations in structuring an employee benefit plan. The most important consideration with respect to profitability is the cost to the organization. There are also two employee-related costs. There are costs to the employee in terms of the payroll deductions required for participation in benefit programs and the amount of other out-of-pocket costs the employee incurs to purchase coverages that are not provided in the benefit and service package. Also, there is the important consideration of the value to the employee. Any benefit program will be a waste of money if the employees perceive no usefulness from the benefits and services offered.

Any benefit program will have to include the mandatory costs of legislated programs such as social security, unemployment compensation, and workers' compensation. Nevertheless, these programs should be carefully considered to avoid any overlap in coverage. Private plans can be tailored to supplement public assistance and as the latter is increased, some reduction in organization benefits can be considered. Pension plans can be integrated with Social Security benefits. Health insurance can carve out Medicare eligibles. Disability insurance can be integrated with workers' compensation. Educational assistance can be made conditional upon the use of available veterans assistance.

A benefit plan should also be cost-effective in terms of employee contributions. This would entail the standard practice of having deductibles for health insurance coverage and schedules of maximum payments and copayments for certain coverages. In other areas, educational assistance can require that the courses taken have some relation to job duties. Also, it may not be economical to provide a standard amount of life insurance for all employees. Younger employees or single workers may not need coverage as extensive as that required by workers with families or older employees.

One way to make sure that benefits are cost-effective is to provide the benefits and services most valued by employees. Benefits systems have tended to grow and change in response to outside events rather than for the purpose of meeting changed employee needs or improving

organizational effectiveness. The most frequent example of this error in thinking is illustrated by similar organizations attempting to duplicate each other's benefit packages. What is good for one company may not always hold true for the next organization.

9.3 Flexible Spending Accounts

A flexible spending account (FSA), also known as a cafeteria plan, allows employees to receive a specific value for the amount of benefits they may choose from a menu of different items. Employees may choose medical, dental and optical benefits, as well as child care, while paying for these costs with pre-tax dollars. Because FSAs are funded with pre-tax dollars, the employer also saves its share of payroll taxes. If designated amounts are not reimbursed during the year or within a short 2½ month window following year end, the employee forfeits the unused portion back to the employer. FSA plans can also be established solely to cover the employee portion of health insurance premiums, otherwise known as a "premium only plan" (POP).

9.4 Health Savings Accounts

Employers may establish health savings accounts (HSAs) for the benefit of employees. An HSA is a custodial account for the sole purpose of paying qualified medical expenses of the account owner in a tax-free manner (health savings accounts are more fully described in the *Insurance* chapter). A high deductible health plan is required to participate in an HSA. Employers may, but are not required to, contribute to an HSA on behalf of an employee. Employer contributions are not included in the employee's income and are not subject to employment taxes. HSA contributions cannot be recovered once made by an employer even in the event an employee terminates prior to earning the employer's contribution.

9.5 Health Reimbursement Arrangements

Employers may also establish a health reimbursement arrangement (HRA), by reimbursing employees for qualified medical expenses which are substantiated to the employer (health reimbursement arrangements are more fully described in the *Insurance* chapter). Under an HRA, all funding is done by the employer up to a maximum reimbursement which the employer determines. Unused amounts may be carried over to future years to increase the maximum reimbursement. Reimbursements

are excluded from the employee's taxable income and are not subject to other payroll taxes.

10. FLEXIBLE WORK ARRANGEMENTS

The objective of any benefit program is to create more satisfied employees, thereby improving performance and positively affecting the bottom line. It is short-sighted to view the costs of providing flexible work arrangements without weighing in the many benefits to the company.

These benefits include managing diversity, enhancing the work-family-life balance, improving the level of staff retention, gaining a recruitment advantage, managing seasonality, improving client services, improving productivity, facilitating education, reducing office space and capital requirements, reducing absenteeism, and enhancing morale.

10.1 Types of Flex Arrangements

Flexible work arrangements don't mean the same thing for every employer. As the name implies, they should create a win-win arrangement which meets the needs of both employer and employee. In each situation this may result in flextime, compressed workweeks, regular part-time, job sharing, work sharing, telecommuting, or sabbaticals.

Given an increasingly diverse workforce, different flex arrangements may be provided to different employees without being discriminatory. In reality, many employees prefer the structure of a regular schedule in an office environment. Both men and women have benefited from such arrangements, particularly in solving child-care or elder-care problems. Flexible arrangements also work in positions of responsibility and generally are not disruptive if managed well. Supervision of flexible work arrangements requires a new kind of management style that emphasizes results rather than oversight, an approach that is necessary to compete in the twenty-first century.

10.2 Flextime

Flextime allows employees to choose their starting and quitting times within limits set by management. A "core time" may be established during which all employees are expected to be present with all other time identified as "flexhours." This requires trust and is a means of empowering staff. The business needs of the company, however, are paramount. Flex programs may need curtailing during busy seasons. Open communication is necessary to ensure that some employees are not overburdened by another's flex schedule.

10.3 Compressed Workweeks

A compressed workweek is a standard workweek that is compressed into fewer than five days. Organizations need to determine if such a schedule would be implemented on an individual basis, within a department, or company-wide. Demographics of the workforce is an important consideration as significantly longer workdays may present problems for parents with younger children or older employees.

Federal and state labor laws should be closely reviewed. The Fair Labor Standards Act requires most employers to pay overtime after forty hours. In certain states overtime must be paid for hours worked in excess of eight a day. Companies requiring full-service coverage over five days may overlap shifts or stagger schedules so that all positions remain covered each day. It is important to ensure that such schedules

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coincide with transit system and public transportation availability. Compressed schedules may also require companies to revise vacation and holiday policies in terms of hours rather than days off.

10.4 Job Sharing

Job-sharing and work-sharing arrangements require regular part-time personnel who are part of the core work force and routinely work less than a normal workweek. For most, a part-time arrangement is transitory—allowing them to balance work with some other aspect of their life. Policies should clearly define the circumstances for returning to full-time status in the future and the effect part-time status has on the company's fringe benefit plans.

Job sharing splits the responsibilities of a full-time position. This requires a team approach and good communication. It can also provide valuable mentoring and cross-training of skills as job sharers tend to supervise each other's work. These attributes improve quality assurance and encourage self-empowerment and self-supervision.

10.5 Telecommuting

Flexplace, or telecommuting, refers to staff working in a remote location (generally at home) part of the time. Telecommuting is advantageous where some types of work can be done more effectively outside the office environment with its ringing telephones, distractions, and interruptions.

Telecommuting requires an employee be self-motivated and disciplined. Employees need to evaluate their own strengths and weaknesses and decide if lack of interaction with others enhances or detracts from job productivity and satisfaction. Such arrangements should only be considered after employees are experienced in their duties and familiar with policies and procedures.

Employers should consider the confidentiality of company and customer data kept off-site and whether additional insurance coverage may be needed. Remote locations generally need an investment in technology and office furnishings and policies should address who is responsible for these costs. Technology may include computer, modem, specific software, printer, scanner/fax/copier, additional phone lines, and courier services. Using appendix 20, "Checklist for an Office at Home" (on the *Toolkit CD-ROM*), is a good way to establish basic home office criteria.

10.6 Leaves and Sabbaticals

Leaves and sabbaticals are authorized paid or unpaid periods of time away from work without loss of employment rights. In many cases, the Family and Medical Leave Act now mandates unpaid leave rights for the birth or placement for adoption or foster care of a child, or for a serious health condition of any family member. Sabbaticals may also be granted to long-time employees to restore vitality and prevent burn-out and stress-related illnesses. Employers need to consider how to cover an employee's work during a leave and what positions will be available when an employee is prepared to return full-time.

11. TERMINATION

11.1 Performance Evaluation and Documentation

Measurement of performance is one of the most crucial tasks performed by managers and supervisors. Although performance evaluation may seem to be directly related only to discussions that occur at salary evaluations, it is a topic relevant to many other day-to-day activities in the workplace. Performance evaluation is actually an ongoing communication effort, beginning with the initial job interview, and continuing throughout the employment cycle.

An employee's history of not meeting performance requirements is often the cause for termination. Failure to communicate performance requirements fully is often the underlying problem if a company is faced with employment-related litigation. Inability to meet performance standards must be fully documented in order to support a termination decision. In order to reduce the potential for any future problems, it is essential that performance requirements, and the employee's record of meeting or not meeting those requirements, be communicated at the time an employee is hired, regularly during employment, and again at employment termination.

11.2 Guidelines for Termination

Prior to terminating an employee, the company should consider several questions:

- Does the organization have options other than termination?
- Should management seek a voluntary resignation instead of a termination accompanied by the employee's signed release of all claims?

- How should the grounds for dismissal be worded in order to avoid any potential discrimination lawsuit?
- Should a peer review board or committee be instituted to resolve disputes over potential terminations?
- What individual within the organization should notify the employee of the impending termination?
- When should a terminated employee be physically released from the organization?
- How are inquiries from the outside handled and by whom?
- What impact will a termination have on the company image, operations, and remaining employee morale?
- What sorts of severance benefits, if any, should be offered the terminee, and under what circumstances?
- What formula should be developed and used to compute the severance and compensation package?
- What company benefits are to continue after the termination and for how long?
- Should job outplacement be considered for the terminated employee?

11.3 Prior to Finalizing a Termination Decision

If termination is being considered due to a violation of company policy, it is imperative that the company adhere to the procedures listed below. Following these procedures will help to protect the company's position if the employee were to sue for wrongful discharge.

— Document all pertinent facts. Documentation of policy infractions is the basis for a "good cause" defense. This documentation should begin at the time infractions, and related disciplinary actions, present the possibility of dismissal. Every violation of policy, regardless of how trivial, should be recorded in the employee's personnel file. All records of violations should fully indicate the resulting disciplinary action, whether formal or informal.

— Use progressive discipline. Establish formal, written guidelines for discipline and follow them rigorously. Under a typical progressive discipline system, an employee will be given an oral warning for the first offense, a written warning for the second, and suspension or termination for the third. If a suspension procedure is implemented,

termination would not normally occur until the fourth offense. The system should also provide for immediate dismissal under certain conditions, such as gross unprofessional conduct, or other activities that management deems highly inappropriate or damaging.

If termination is considered due to repeated poor performance, the performance evaluation process must be scrutinized. In order to defend its position, management should be able to answer the following questions based upon the company's performance evaluation process as it relates to the terminated employee:

- Is it obvious what activity/job/position is being evaluated?
- Are the performance objectives explicit, fair, and realistic?
- Is the evaluation objective, fair, and unbiased as to sex, race, religion, handicap, and national origin?
- Was the employee told of the performance evaluation and notified of the functional areas where performance needed improvement?
- What performance standards are used to evaluate the employee's performance?
- Are the performance criteria and/or performance standards ever changed? If so, the following questions must also be addressed:
  - Are the changes explicitly and formally communicated to the affected employee?
  - Are copies of these communications permanently maintained?
- Are performance standards based on the job analysis?
- Are the same job performance standards applied to all employees holding similar jobs?
- Were the evaluations consistent with sound personnel practices?
- Were the evaluations done by a person thoroughly familiar with the terminated employee's performance?
- Has the employee been given appropriate assistance and guidance toward reaching objectives?
- Were the necessary resources made available to reach the established objectives and standards?
- Does the company provide necessary training to enable the employee to keep relevant knowledge up-to-date?
- Were unsatisfactory performance issues discussed with the employee at reasonable intervals?
- Was the employee advised of the consequences of continued unsatisfactory performance?

— Were deadlines provided for remedial actions?
— Is the company's performance evaluation program formal and has it been formally communicated to employees?
— Have employees ever been evaluated as satisfactory even though the performance was poor, unsatisfactory, or marginally satisfactory?
— Is a complete and accurate file of each employee's performance evaluations maintained? If so, also address the following:
— Does this file support the termination?

Answers to these questions should enable management to assess its position in potential termination based on poor or unsatisfactory performance. Questions that cannot be answered positively and explicitly must alert management to reevaluate its stand on a discharge on grounds of unsatisfactory performance. See Hiring Foreign Nationals section 2.3.6 for special considerations regarding terminating H-1B employees.

11.4 After the Decision to Terminate Has Been Finalized

After the termination decision has been made, several steps should be taken to prepare for the termination interview:

- Check whether there is any employment contract for a definite term.
- Carefully review each provision in the employee handbook.
- Make sure that an impartial third party has reviewed all facts.
- Determine the reason that is to be given for the termination.
- Draft the termination letter.
- Keep a record of the termination notice and all termination-related documents.
- Notify those who are likely to be affected by the termination.
- Employees who could potentially be harmful to the company must be asked, and should be asked, to leave the premises soon after termination notice is given. Compensation in lieu of advanced notice should be arranged.
- Exercise extreme confidentiality in handling terminations.
- Be prepared to ensure a replacement for the terminated employee if the position is not being abolished.
- Scrutinize the details of the severance package.
- Be sensitive to the time in which the employee is notified.

11.5 During the Termination Interview

During the termination interview, several important steps should be followed:

- Come to the point within the first two to three minutes.
- Outline and put into a logical order all the relevant reasons for the termination.
- Keep the termination interview brief and businesslike.
- Determine the terms to be used for the employee's departure.
- Preferably, conduct the exit in a neutral territory.
- Inform the employee of the "bad news" in a way that will alleviate trauma.
- Do not try to compensate the terminated employee for the "psychological shock" of losing the job.
- Offer assistance in helping this person find another job.

11.6 After the Termination Interview

Once the termination interview is complete, be sure the following additional steps are completed:

- Notify all the departments within your organization that are apt to be affected by the employee's departure.
- Have the employee return all company property and make sure that the employee's financial obligations to the firm are cleared.
- Find out whether the employee has any vested rights to the pension, profit sharing, or other related plans.
- Inform the departing employee the kind of contact the company will allow from them after he or she leaves.
- Inform the employee what to expect in terms of future references.
- If you are to assist with outplacement, stay in contact and follow through accordingly.

Perform an exit interview, if possible. See appendixes 21 through 23 (on the *Accountant's Business Manual Toolkit CD-ROM*) for examples of exit interview and related termination forms.

Employee terminations are an extremely serious and sensitive subject and should be treated as such by all managers, executives, and owners. Whether a termination results in a potential lawsuit for wrongful

discharge will often depend on how the termination process is handled. Lawsuits are not only expensive, but are embarrassing to both the terminating organization and the terminated employee. Every effort should be made to ensure that terminations, when inevitable, have been properly handled by management.

SUGGESTED REFERENCES

For publications devoted to specific aspects of human resources and employment law, it is suggested that the reader refer to a specific legal publisher's site or conduct a Web search. Useful sites include www.aspenpublishers.com, www.bender.com, www.cch.com, and www.westgroup.com.

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Federal Individual Tax Notes

FEDERAL INDIVIDUAL TAX NOTES

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1. HURRICANES KATRINA, RITA, AND WILMA RELIEF: GULF OPPORTUNITY ZONE ACT OF 2005

1.1 Introduction

During the fall of 2005, Congress passed legislation to provide immediate relief to individuals and businesses affected by Hurricane Katrina. That legislation was called the Katrina Emergency Tax Relief Act of 2005 (H.R. 3768), with the legislation signed by the President on September 23, 2005.

In response to the devastation of Hurricane Katrina, along with Hurricanes Rita and Wilma, Congress passed the Gulf Opportunity Zone Act (GOZA) of 2005, with this legislation signed by the President on December 21, 2005. GOZA includes a significant number of federal tax incentives to encourage rebuilding and economic recovery in areas affected by Hurricanes Katrina, Rita, and Wilma. However, the legislation also enacts provisions that are totally unrelated to hurricanes.

1.2 Gulf Opportunity Zone Act of 2005 (P.L. 109-135)

While GOZA establishes new tax breaks for individuals and business affected by the hurricanes, some of the GOZA relief measures are simply extensions of tax breaks initially included in the Katrina Emergency Tax Relief Act of 2005.

1.2.1 Geographical areas that qualify for the GOZA relief provisions

There are six separate geographic areas affected by the GOZA legislation.

1.2.1.1 Hurricane Katrina GO Zone

The Gulf Opportunity (GO) Zone is defined as that portion of the Hurricane Katrina Disaster Area determined by the President to warrant individual or individual and public assistance from the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina. This is the same definition as was given to the Hurricane Katrina Core Disaster Area established by the Katrina Emergency Tax Relief Act.

The Katrina GO Zone covers Louisiana, Mississippi, and Alabama.

Louisiana: The parishes of Acadia, Ascension, Assumption, Calcasieu, Cameron, East Baton Rouge, East Feliciana, Iberia, Iberville, Jefferson, Jefferson Davis, Lafayette, Lafourche, Livingston, Orleans, Plaquemines, Pointe Coupee, St. Bernard, St. Charles, St. Helena, St. James, St. John the Baptist, St. Martin, St. Mary, St. Tammany, Tangipahoa, Terrebonne, Vermillion, Washington, West Baton Rouge, and West Feliciana.

Mississippi: The counties of Adams, Amite, Attala, Choctaw, Claiborne, Clarke, Copiah, Covington, Forest, Franklin, George, Greene, Hancock, Harrison, Hinds, Holmes, Humphreys, Jackson, Jasper, Jefferson, Jefferson Davis, Jones, Kemper, Lamar, Lauderdale, Lawrence, Leake, Lincoln, Lowndes, Madison, Marion, Neshoba, Newton, Noxubee, Oktibbeha, Pearl River, Perry, Pike, Rankin, Scott Simpson, Smith, Stone, Walthall, Warren, Wayne, Wilkinson, Winston, and Yazoo.

Alabama: The counties of Baldwin, Choctaw, Clarke, Greene, Hale, Marengo, Mobile, Pickens, Sumter, Tuscaloosa, and Washington.

Florida: No counties eligible.

Observation

Many of the GOZA hurricane relief tax breaks are targeted to benefit the Katrina Gulf Opportunity (GO) Zone, not the Rita or Wilma GO Zones.

1.2.1.2 Hurricane Katrina Disaster Area

The Hurricane Katrina Disaster Area means an area with respect to which a major disaster was declared by the President prior to September 14, 2005, under Section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina.

The Hurricane Katrina Disaster Area includes all of Louisiana, Mississippi, Alabama, and Florida.

1.2.1.3 Hurricane Rita GO Zone

The Rita GO Zone means that portion of the Hurricane Rita Disaster Area determined by the President to warrant individual or individual and public assistance from the Federal Government under Section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina.

The Rita GO Zone includes southern Louisiana and southeastern Texas.

Louisiana: The parishes of Acadia, Allen, Ascension, Beauregard, Calcasieu, Cameron, Evangeline, Iberia, Jefferson, Jefferson Davis, Lafayette, Lafourche, Livingston, Plaquemines, Sabine, St. Landry, St. Martin, St. Mary, St. Tammany, Terrebonne, Vermillion, Vernon, and West Baton Rouge.

Texas: The counties of Angelina, Brazoria, Chambers, Fort Bend, Galveston, Hardin, Harris, Jasper, Jefferson, Liberty, Montgomery, Nacogdoches, Newton, Orange, Polk, Sabine, San Augustine, San Jacinto, Shelby, Trinity, Tyler, and Walker.

1.2.1.4 Hurricane Rita Disaster Area

The Hurricane Rita Disaster Area means an area with respect to which a major disaster was declared by the President prior to October 6, 2005, under Section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act, by reason of Hurricane Rita.

The Hurricane Rita Disaster Area includes all of Louisiana and Texas.

1.2.1.5 Hurricane Wilma GO Zone

The Wilma GO Zone means that portion of the Hurricane Wilma Disaster Area determined by the President to warrant individual or individual and public assistance from the Federal Government under Section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Wilma.

The Wilma GO Zone covers southern Florida.

Florida: The counties of Brevard, Broward, Collier, Glades, Hendry, Indian River, Lee, Martin, Miami-Dade, Monroe, Okeechobee, Palm Beach, and St. Lucie.

1.2.1.6 Hurricane Wilma Disaster Area

The Hurricane Wilma Disaster Area means an area with respect to which a major disaster was declared by the President prior to November 14, 2005, under Section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act, by reason of Hurricane Wilma.

The Hurricane Wilma Disaster Area covers all of Florida.

1.2.2 Five-year NOL carryback for losses in Katrina GO Zone

A special five-year carryback period, instead of the normal two-year period, is allowed for net operating losses attributable to certain Katrina GO Zone expenditures and casualty losses. Additionally, the rule that generally limits a taxpayer's NOL deduction to 90 percent of alternative minimum taxable income does not apply to any NOL subject to this special five-year carryback. Accordingly, such NOLs can be used to offset up to 100 percent of alternative minimum taxable income. Taxpayers are allowed to elect to forego the five-year carryback privilege. Other restrictions and privileges apply.

1.2.3 Expanded education credits for students in the Katrina GO Zone

The Hope and Lifetime Learning education credits are expanded for students attending an eligible educational institution located in the Katrina GO Zone.

For such students, the Hope Credit is increased to 100 percent of the first $2,000 ($2,200 in 2006) of qualified tuition and related expenses and 50 percent of the next $2,000 ($2,200 in 2006) of qualified tuition and related expenses, for a maximum credit of $3,000 in 2005 and $3,300 in 2006 per student. The Lifetime Learning credit is increased from 20 percent to 40 percent and the definition of qualified expenses is expanded to mean qualified higher education expenses as defined under the rules relating to qualified tuition programs, including certain room and board expenses for at least half-time students. The expanded education credits apply to taxable years beginning in 2005 and 2006.

1.2.4 Housing relief for individuals affected by Katrina

Qualified employees are allowed to exclude up to $600 per month of in-kind lodging provided by a qualified employer from gross income. The exclusion applies for federal income tax purposes only, and not for Social Security, Medicare, or unemployment taxes. Additionally, qualified employers are allowed a temporary credit equal to 30 percent of the value of lodging excluded from the income of a qualified employee. The amount taken as a credit is not deductible by the employer.

A qualified employee means one, with respect to a month, who: (1) on August 28, 2005, had a principal residence in the Katrina GO Zone, and (2) performed substantially all of his or her employment services in the Katrina GO Zone for the qualified employer furnishing the lodging. Qualified employer means any employer with a business located in the Katrina GO Zone.

This provision applies to lodging provided during the period beginning on January 1, 2006, through June 30, 2006.

1.3 Tax Benefits Related to Hurricanes Rita and Wilma

1.3.1 Special rules for use of retirement funds for relief relating to hurricanes

1.3.1.1 Penalty-free withdrawals from retirement plans

The Katrina Emergency Tax Relief Act of 2005 allowed up to $100,000 in "qualified Hurricane Katrina distributions" from retirement plans

to be exempt from the 10 percent early withdrawal penalty of Section 72(t).

A "qualified Hurricane Katrina distribution" is any distribution:

1. From an "eligible retirement plan" defined as:
   a) An IRA,
   b) An IRA annuity, other than an endowment contract,
   c) A Section 401(a) qualified trust,
   d) A Section 403(a) qualified annuity plan,
   e) A Section 457(b) eligible deferred compensation plan maintained by a governmental employer, and
   f) A Section 403(a) annuity contract.
2. Made on or after August 25, 2005, and before January 1, 2007,
3. To an individual whose principal place of abode on August 28, 2005, was located in the Hurricane Katrina disaster area, and
4. Who sustained an economic loss due to Hurricane Katrina.

Taxpayers are allowed to recontribute qualified Hurricane Katrina distributions to eligible retirement plans or IRAs tax-free at any time during the three-year period beginning on the day after the date of the distribution, with the aggregate amount of such recontributions limited to the aggregate amount of the qualified Hurricane Katrina distributions made to the taxpayer.

Taxpayers are also allowed to include qualified Hurricane Katrina distributions in taxable income on a pro-rata basis over the three taxable year period beginning with the year the distribution is received. Taxpayers are allowed to elect not to have the three-year income averaging provision apply.

> *Example.* Linda receives a $60,000 qualified Hurricane Katrina distribution during 2006 for personal living expenses. Unless Linda elects otherwise, the $60,000 distribution will result in $20,000 of income being reported in each of her 2006, 2007, and 2008 Forms 1040.

The Gulf Opportunity Tax Act of 2005 expanded the relief provided under the Katrina Emergency Tax Relief Act of 2005 in the case of qualified Hurricane Katrina distributions to any "qualified hurricane distribution," which is defined to include distributions related to Hurricanes Rita and Wilma. A qualified hurricane distribution includes distributions that meet the definition of qualified Hurricane Katrina distributions under the Katrina Emergency Tax Relief Act of 2005, as well as any other distribution from an eligible retirement plan made on or after September 23, 2005, and before January 1, 2007, to an individual whose principal place of abode on September 23, 2005, is located in the Hurricane Rita disaster area and who sustained an economic loss by reason of Hurricane Rita.

A qualified hurricane distribution also includes a distribution from an eligible retirement plan made on or after October 23, 2005, and prior to January 1, 2007, to an individual whose principal place of abode on October 23, 2005, is located in the Hurricane Wilma disaster area and who sustained an economic loss by reason of Hurricane Wilma.

The total amount of qualified hurricane distributions that an individual can receive from all plans, annuities, or IRAs is $100,000.

1.3.1.2 Recontributions of withdrawals for home purchases cancelled due to hurricanes

The Katrina Emergency Tax Relief Act of 2005 allowed specific retirement plan or IRA withdrawals for home purchases that were cancelled due to Katrina to be repaid to a qualified plan or IRA tax-free and without penalty. Examples of such specific withdrawals include hardship distributions from a qualified plan to purchase a home or IRA withdrawals under the first-time homebuyer rule.

A qualified distribution amount must have been received by the taxpayer after February 28, 2005, and before August 29, 2005, with the distribution intended to be used to purchase or construct a principal residence in the Katrina disaster area, with the purchase or construction not occurring due to the Katrina disaster.

The Gulf Opportunity Zone Act expanded the provision under the Katrina Emergency Tax Relief Act of 2005, allowing recontribution of certain distributions from a 401(k) plan, 403(b) annuity, or IRA for qualified Hurricane Rita distributions and for qualified Hurricane Wilma distributions.

A qualified Hurricane Rita distribution is a hardship distribution from a 401(k) plan or 403(b) annuity, or a qualified first-time home buyer distribution from an IRA:

1. That is received after February 28, 2005, and before September 24, 2005, and
2. That was to be used to purchase or construct a principal residence in the Hurricane Rita disaster area, but the residence is not purchased or constructed on account of Hurricane Rita.

Any portion of a qualified Hurricane Rita distribution may, during the period beginning on September 23, 2005, and ending on February 28, 2006, be recontributed to a plan, annuity, or IRA to which a rollover is permitted.

A qualified Hurricane Wilma distribution is a hardship distribution from a 401(k) plan or 403(b) annuity, or a qualified first-time home buyer distribution from an IRA:

1. That is received after February 28, 2005, and before October 24, 2005, and

2. That was to be used to purchase or construct a principal residence in the Hurricane Wilma disaster area, but the residence is not purchased or constructed on account of Hurricane Wilma.

Any portion of a qualified Hurricane Wilma distribution may, during the period beginning on October 23, 2005, and ending on February 28, 2006, be recontributed to a plan, annuity or IRA to which a rollover is permitted.

1.3.1.3 Loans from qualified plans relating to hurricanes

The Katrina Emergency Tax Relief Act of 2005 allowed amounts withdrawn as a loan from a qualified employer plan to be increased to the amount of $100,000 (normally $50,000) or the greater of $10,000 or the present value of the employee's nonforfeitable accrued benefit under the plan (normally the greater of $10,000 or one-half of the present value) for victims of Katrina. Additionally, a one-year postponement of payments for existing plan loans is allowed.

A qualified individual for purposes of this provision means an individual whose principal place of abode on August 28, 2005, was located in the Katrina disaster area and who sustained an economic loss by reason of Katrina. The special rules for loans from a qualified employer plan provided under the Katrina Emergency Tax Relief Act of 2005 were expanded to loans from a qualified employer plan to a qualified Hurricane Rita or Hurricane Wilma individual made on or after December 21, 2005, and before January 1, 2007.

A qualified Hurricane Rita individual includes an individual whose principal place of abode on September 23, 2005, is located in the Hurricane Rita disaster area and who sustained an economic loss by reason of Hurricane Rita. In the case of a qualified Hurricane Rita individual with an outstanding loan on or after September 23, 2005, from a qualified employer plan, if the due date for any repayment with respect to such loan occurs during the period beginning on September 23, 2005, and ending on December 31, 2006, the due date is delayed by one year.

A qualified Hurricane Wilma individual includes an individual whose principal place of abode on October 23, 2005, is located in the Hurricane Wilma disaster area and who sustained an economic loss by reason of Hurricane Wilma. In the case of a qualified Hurricane Wilma individual with an outstanding loan on or after October 23, 2005, from a qualified employer plan, if the due date for any repayment with respect to the loan occurs during the period beginning on October 23, 2005, and ending on December 31, 2006, the due date is delayed by one year.

An individual cannot be a qualified individual with respect to more than one hurricane.

1.3.1.4 Provisions relating to plan amendments

The Katrina Emergency Tax Relief Act of 2005 allowed a qualified plan or IRA to implement legislative or regulatory changes associated with Katrina relief without first having to amend the qualified plan or IRA itself.

The provision to make retroactive plan amendments under the Katrina Emergency Tax Relief Act of 2005 was expanded to apply to changes made pursuant to new Section 1400Q, dealing with the special rules for use of retirement funds described in Section 1.3.1, preceding.

1.3.2 Employment relief

1.3.2.1 Employee retention credit for employers affected by hurricanes

A new tax credit is added, computed as 40 percent of the first $6,000 of qualified wages per employee paid by an eligible employer to an eligible employee.

An eligible employer is one which conducted an active business on August 28, 2005, in the Katrina core disaster area and for whom the business is operable on any day after August 28, 2005, and before January 1, 2006, because of Katrina damage. But see the modification to this definition of an eligible employer, following.

Caution

The credit is only allowed for small businesses which employed an average of 200 or less employees on business days during the taxable year.

The Gulf Opportunity Zone Act of 2005 modified the provisions that were enacted in the Katrina Emergency Tax Relief Act of 2005 by eliminating the provision that restricted the credit to employees of not more than 200 employees.

Additionally, the employer retention credit, as modified to eliminate the employer size limitation, was extended to employers affected by Hurricanes Rita and Wilma and located in the Rita Gulf Opportunity Zone and the Wilma Gulf Opportunity Zone, respectively. The reference dates for employers affected by Hurricane Rita and Hurricane Wilma, compared to the August 28, 2005, date for employers affected by Hurricane Katrina, are September 23, 2005, and October 23, 2005, respectively.

1.3.3 Charitable giving incentives

1.3.3.1 Temporary suspension of limitations on charitable contributions

The percentage limitation on charitable deductions was temporarily increased by the Katrina Emergency Tax Relief Act of 2005 for qualified contributions made in cash during a specified period. Additionally, such donations were not subject to the overall phase-out limit on Schedule A itemized deductions.

Individual taxpayers were allowed to deduct qualified contributions up to the amount by which the taxpayer's contribution base (that is, the taxpayer's adjusted gross income (AGI) subject to the normal percentage limitation) exceeds the taxpayer's deduction for other qualified charitable contributions.

Additionally, C corporations were allowed to deduct qualified disaster contributions up to the corporation's entire taxable income, less other contributions; however, contributions by C corporations must specifically have been for Katrina relief efforts.

Qualified contributions are cash contributions made during the period beginning on August 28, 2005, and ending on December 31, 2005, to a qualifying charity for which the taxpayer has elected qualified contribution treatment.

> *Example.* Charlie made $17,500 of qualified contributions and $15,000 of other contributions to qualified charities. Charlie's contribution base for 2005 is $25,000.
>
> Charlie was allowed to deduct $25,000 for 2005, an amount equal to his contribution base ($12,500 determined without regard to qualified contributions and $12,500 of qualified contributions). Charlie's carryover contribution amount of $7,500 ($5,000 from unused qualified contributions and $2,500 from unused regular contributions) carry forward to the next five years, subject to the normal 50 percent of AGI limit.

The temporary increase in the percentage limitation on charitable deductions for qualified contributions made in cash during a specified period, as enacted by the Katrina Emergency Tax Relief Act of 2005, was extended by the Gulf Opportunity Zone Act to allow qualified disaster contributions made by C corporations up to the corporation's entire taxable income, less other contributions, to be allowed for contributions specifically for Katrina relief efforts and also for contributions for relief efforts related to Hurricane Rita and Hurricane Wilma.

1.3.4 Additional tax relief provisions

1.3.4.1 Suspension of limitations on personal casualty losses

The Katrina Emergency Tax Relief Act of 2005 included a provision such that the $100 per casualty or theft loss floor and the 10 percent-of-AGI floor do not apply to a taxpayer's casualty or theft losses arising in the Katrina disaster area on or after August 25, 2005. However, other casualty losses are still subject to the normal $100 and 10 percent-of-AGI limitations. The Gulf Opportunity Zone Act of 2005 expanded the provision to include losses that arose in the Hurricane Rita disaster area and are attributable to Hurricane Rita and losses that arose in the Hurricane Wilma disaster area and that are attributable to Hurricane Wilma.

1.3.4.2 Special rule for determining earned income

The Katrina Emergency Tax Relief Act of 2005 enacted a provision, such that qualified individuals were allowed to elect to calculate their earned income credit and refundable child tax credit for their taxable year, which includes August 25, 2005, using their earned income from the previous taxable year, if their earned income from the previous year exceeds their earned income for the taxable year that includes August 25, 2005.

In order to qualify, taxpayers needed to have their principal place of abode on August 25, 2005, in either the core disaster area or the Katrina disaster area, with the taxpayer displaced from the principal place of abode by reason of Katrina.

The Gulf Opportunity Zone Act of 2005 expanded the rule governing Katrina elections to permit certain qualified individuals affected by Hurricane Rita and Hurricane Wilma to make similar elections.

In the case of Hurricane Rita, certain qualified individuals could elect to calculate their earned income credit and refundable child tax credit for the taxable year which included September 23, 2005, using their earned income from the prior taxable year. Qualified individuals for purposes of this election include:

1. Individuals who on September 23, 2005, had their principal place of abode in the Rita Gulf Opportunity Zone, or
2. Individuals who on September 23, 2005, had their principal place of abode in the Hurricane Rita disaster area but outside the Rita Gulf Opportunity Zone and were displaced from that residence.

In the case of Hurricane Wilma, certain qualified individuals could elect to calculate their earned income credit and refundable child tax credit for the taxable year which included October 23, 2005, using their

earned income from the prior taxable year. Qualified individuals for purposes of this election include:

1. Individuals who on October 23, 2005, had their principal place of abode in the Wilma Gulf Opportunity Zone, or
2. Individuals who on October 23, 2005, had their principal place of abode in the Hurricane Wilma disaster area but outside the Wilma Gulf Opportunity Zone and were displaced from that residence.

Qualified individuals are permitted to make an election pertaining to Hurricane Rita or Hurricane Wilma only if their earned income for the taxable year which includes September 23, 2005, or October 23, 2005, respectively, is less than their earned income for the preceding taxable year.

In all other respects, an election related to Hurricane Rita or Hurricane Wilma is the same as an election related to Hurricane Katrina, as enacted under the Katrina Emergency Tax Relief Act of 2005, except that the reference dates are September 23, 2005, for Hurricane Rita and October 23, 2005, for Hurricane Wilma, as opposed to August 25, 2005, for Hurricane Katrina.

1.3.4.3 IRS authority to make adjustments regarding taxpayer dependency status

Under the Katrina Emergency Tax Relief Act of 2005, the IRS was given the authority for taxable years beginning in 2005 or 2006 to make adjustments that may be necessary to ensure taxpayers do not lose any deduction or credit, or experience a change in filing status, by reason of temporary relocation due to Katrina.

Under the Gulf Opportunity Zone Act of 2005, the authority of the IRS to make adjustments that may be necessary to ensure taxpayers do not lose any deductions or credit, or experience a change in filing status, was expanded to include taxpayers affected by Hurricane Rita and Hurricane Wilma.

1.4 Other Provisions in the Gulf Opportunity Zone Act of 2005

1.4.1 Election to treat combat pay as earned income for purposes of the earned income credit

Taxpayers were allowed to treat combat pay otherwise excludable from gross income under Section 112 as earned income for purposes of computing the earned income credit. However, this election was only available with respect to any taxable year ending prior to January 1, 2006.

The Gulf Opportunity Zone Act of 2005 has extended this provision relating to the earned income credit for one year, through December 31, 2006.

1.5 Technical Corrections Enacted as Part of the Gulf Opportunity Zone Act of 2005

The Gulf Opportunity Zone Act of 2005 enacted a significant number of technical corrections, many of them minor in nature. Those technical corrections of greater significance are discussed in other areas of this material. Accordingly, a separate discussion of tax technical corrections enacted as part of the Gulf Opportunity Zone Act of 2005 is not included in this section.

2. INDIVIDUAL INCOME DEVELOPMENTS

2.1 Section 529 Plans

2.1.1 Background

Section 529 qualified tuition plans are authorized as either prepaid tuition plans or college savings plans. Prepaid tuition plans allow the investment to grow at the rate of inflation applicable to the state's higher education system or that of an eligible education institution, whereas a college savings plan is essentially a state-sponsored mutual fund under which the value changes based on the performance of the underlying investments.

Contributions to a Section 529 plan are nondeductible when made, but any growth in the investment occurs in a tax-free manner, assuming distributions from the Section 529 plan are ultimately used for qualified higher education expenses (tuition, room and board, books, and supplies).

As originally enacted, all provisions of Section 529 plans were scheduled to sunset on December 31, 2010. This included the ability to take tax-free distributions when used for the qualified higher education expenses, permitted rollovers from one account to another, the treatment of room and board as qualifying education expenses, coordination of the Section 529 rules with the Hope and Lifetime Learning credits, and a number of other detailed provisions of Section 529 plans.

2.1.2 Section 529 provisions made permanent

The Pension Protection Act of 2006 has made all provisions related to Section 529 plans a permanent part of the Code (Act Sec. 1304(a), amending Sec. 901 of the Economic Growth and Tax Relief Reconciliation Act of 2001).

Additionally, the Pension Protection Act of 2006 granted Treasury regulatory authority to clarify the tax treatment for certain transfers associated with Section 529 plans and to minimize abuse of such arrangements [Act Sec. 1304(b), adding §529(f)].

Example. Joe was a wealthy individual with five grandchildren. During 2006, Joe contributes $60,000 to a Section 529 plan on behalf of each grandchild, using the privilege that permits a contributor to treat the $60,000 amount as a contribution of $12,000 (2006 gift tax exclusion amount) for each of the next five years. In doing this, Joe intends to subsequently change the designated beneficiary of each account to his favorite grandchild, Sally, followed by distribution of the amounts to Sally personally.

The Committee Report to the Pension Protection Act of 2006 indicates that regulatory authority is granted to Treasury to prevent such an abuse of the intent of Section 529 plans from occurring.

2.2 State Taxation of Retirement Payments to Nonresident Partners

2.2.1 Background

Prior to 1996, workers who lived and worked in one state but then retired and moved to another state and collected a pension were often taxed by the state in which they originally lived and worked. This occurred even if the taxpayer was no longer a resident of that state, resulting in some retirees being subject to double taxation and the complexity of dealing with multistate returns.

Under a 1996 legislative change, states were prohibited from subjecting retirement income of an individual to income taxation in situations in which the individual was not a resident of the state at the time the income was received (P.L. 104-95, 1/10/1996).

This resulted in pension and other types of retirement distributions being protected from source taxation for several types of distributions, as follows:

- A qualified pension, profit sharing, or stock bonus plan, including Section 401(k) plans.
- Simplified employee pensions (SEPs).
- Section 403(b) tax-sheltered annuities.

- An IRA or IRA annuity.
- A Section 457 deferred compensation plan, for employees of tax-exempt organizations or state or local governments.
- A Section 414(d) governmental plan.
- A Section 501(c)(18) plan.

Additionally, three categories of nonqualified plan distributions were protected, as follows:

- Deferred compensation plans if payments were made at least annually and spread over the actuarial life of the beneficiaries.
- Similar plans if they spread payments over at least a 10-year period.
- Plans which are trusts under Section 401(a), but exceed limits as specified in Sections 401(a)(17), 401(k), 401(m), 402(g), 403(b), 408(k), or 415.

This change was enacted in early 1996, effective for amounts received after December 31, 1995.

2.2.2 Taxation of retirement payments to nonresident partners by states disallowed

Legislation has now been enacted during August, 2006 clarifying the treatment of self-employed individuals for purposes of the limitation of state taxation of retirement income (P.L. 109-264, 8/3/2006).

Under this legislation, retirement income of all retirees, whether employees or partners prior to retirement, is treated in the same manner for state tax purposes.

Observation

This legislation was apparently enacted in response to a position taken by the New York State Department of Taxation and Finance, in which that taxing authority determined that the statutory change enacted in January, 1996 did not reach nonqualified retirement benefits paid by a partnership to its retired nonresident partners. Accordingly, New York attempted to argue that Section 3121(v)(2)(C), which applies to nonqualified plan distributions described in the 1996 legislation, applied only to employees, and not to partners.

The August 2006 statutory change amends the 1996 statutory change to block state income taxation of nonqualified deferred compensation plans, as defined in Section 3121(v)(2)(C), and nonqualified retirement benefits paid by a partnership to a retired nonresident partner. The provision applies to amounts received after December 31, 2005. However, because many retirees may have taken a credit for taxes

paid to another state on their home state return, the benefit of filing for a refund on an amended return may be minimal and not justify the effort.

2.3 Foreign Earned Income and Housing Cost Exclusions

2.3.1 Background

U.S. citizens are required to pay income tax on all income, whether derived in the United States or in a foreign country. However, because U.S. citizens may be taxed on that income by the foreign country, the Code provides a credit against U.S. income tax for the foreign income taxes paid on that income.

Additionally, U.S. citizens are entitled to a foreign earned income exclusion for non-U.S. source earned income attributable to personal services performed by the taxpayer during a period of foreign residence or presence.

Observation
The maximum foreign earned income exclusion amount was $80,000 for calendar years 2002 through 2005. The amount was scheduled to index for inflation starting in 2008.

Taxpayers are also entitled to a foreign housing cost exclusion, equal to the excess of the housing expenses over a base housing amount. The base housing amount above which costs are eligible for exclusion is 16 percent of the annual salary computed on a daily basis of a grade GS-14, step 1, U.S. government employee, multiplied by the number of days of foreign residence or presence in the taxable year.

Observation
For 2006, the grade GS-14, step 1 salary is $77,793, resulting in a current base housing amount of $12,447, computed on an annual basis.

2.3.2 Change to annual foreign earned income exclusion amount

The Tax Increase Prevention and Reconciliation Act enacted a change such that the maximum foreign earned income amount is indexed for inflation in taxable years starting in 2006, rather than in 2008.

Observation
Based on this change, the maximum foreign earned income exclusion for 2006 is $82,400.

Changes were also made to the maximum foreign housing cost exclusion, limiting the maximum exclusion to 30 percent of the maximum foreign earned income exclusion.

Observation

The base housing amount used in calculating the foreign housing cost exclusion is 16 percent of the amount computed on a daily basis of the foreign earned income exclusion limitation, multiplied by the number of days of foreign residence or presence for the taxpayer in that year. Under this new rule, the maximum amount of the foreign housing cost exclusion for 2006 is $11,536, computed at 14 percent (30 percent – 16 percent) of $82,400, assuming foreign residence or presence for the entire taxable year.

2.3.3 Change in tax computation with foreign earned income exclusion

Taxpayers who excluded amounts under the foreign earned income and foreign housing cost exclusion are taxable on any income in excess of the exclusion amount for both regular tax and alternative minimum tax purposes by applying the tax rates to the income that would have been applicable had the exclusion amounts not been deducted.

Example. Frank is entitled to a foreign earned income exclusion of $80,000 and a foreign housing cost exclusion of $10,000. Frank's total taxable income is $120,000, before the exclusion amounts are applied.

Previously, Frank would have computed tax on taxable income of $30,000, using the lowest tax rates that apply. Under the change in the Tax Increase Prevention and Reconciliation Act, Frank must compute income tax on the total taxable income amount of $120,000, then compute the income tax on the $90,000 excluded amount, with the difference computed as the tax liability (that is, Frank is paying on $30,000 at higher rates than he did under previous law).

2.3.4 Foreign earned income exclusion not available for Antarctica

The Tax Court has ruled that the foreign earned income exclusion does not apply to a taxpayer's earnings in Antarctica, finding that Antarctica is not considered a foreign country under a 1961 treaty between the United States and other foreign countries (*Arnett v. Comm.*, 126 TC No. 5, 1/25/2006).

Observation

The court cited a previous opinion in *Martin v. Comm.* (50 TC 59, 1968), which also determined that Antarctica was not a foreign country for purposes of the foreign earned income exclusion.

2.4 Principal Residence Gain Exclusion

2.4.1 Background

A taxpayer can elect to exclude up to $250,000 of gain realized on the sale of a residence if it was owned and occupied as a principal residence for an aggregate of at least two of the five years before the sale or exchange [§121(a)]. The excludable amount is $500,000 of gain for a married couple filing jointly if either spouse satisfies the ownership test and both satisfy the use test. The exclusion applies to only one sale or exchange every two years, but pre-May 7, 1997, sales are disregarded. The exclusion does not apply to the extent of any depreciation allowable with respect to the rental or business use of a residence after May 6, 1997. If a taxpayer does not satisfy the two-year ownership or residence requirements, a pro rata portion of the exclusion is allowable if the sale or exchange is the result of a change in place of employment or health, or of unforeseen circumstances. An involuntary conversion of a residence is treated as a sale or exchange under the rules.

Observation

The exclusion replaces the former Section 1034 rollover-of-gain rules and the former Section 121 one-time $125,000 exclusion for taxpayers age 55 or older. However, tax practitioners should recognize that many homeowners currently selling a principal residence have acquired their current residence under the former Section 1034 rollover rules. Those rules deferred the gain from the sale of one residence into the replacement residence, resulting in a lower adjusted tax basis of the replacement residence. The repeal of former Section 1034 has not changed the fact that many current residences have a low tax basis because of prior law.

Definition of a Principal Residence. Regulations clarify that a principal residence may include a houseboat, house trailer, or stock held in a cooperative housing corporation if the dwelling is occupied as a principal residence. If a taxpayer alternates between two properties, using each as a residence for successive periods, the property used a majority of the time during the year is considered the principal residence [Reg. §1.121-1(b)].

2.4.2 Pro-rata gain exclusion

A pro-rated portion of the $250,000 or $500,000 gain exclusion is allowed if a taxpayer fails to meet any of the three eligibility tests (two year ownership, two-year occupancy, or prior sale within two years), if the early disposition occurred by reason of:

1. A change in place of employment,
2. Health reasons, or
3. Other unforeseen circumstances, to the extent provided in regulations [§121(c)(2)].

The portion of the gain exclusion allowed is a fraction, with the numerator calculated as the shorter of the period of actual ownership and use by the taxpayer in the last five years, or the period of time since the taxpayer last claimed a gain exclusion, and the denominator of which is 24 months.

> *Example.* Burt, a single taxpayer, purchases his first residence on September 1, 2005, in Kansas City. A year later, Burt's employer requires him to relocate to northern California. Burt sells the Kansas City residence on October 1, 2006, and realizes a gain of $85,000. Because Gene's sale occurred by reason of a change in employment location, he is entitled to claim a pro-rated portion of the $250,000 gain exclusion. Burt may claim 13/24ths of the $250,000 gain exclusion, which is approximately $135,400. Accordingly, this pro-rated gain exclusion will entirely eliminate any taxable reporting from the sale of the Kansas City residence.

In late 2004, the IRS issued final regulations that clarified eligibility for the pro-rated gain exclusion for those who fail the two-year test upon selling a principal residence. The regulations provide a series of safe harbors for eligibility, and define a number of situations that would qualify for the "unforeseen circumstances" definition (Reg. §1.121-3, T.D. 9152, 8/13/2004).

2.4.3 Guidance on "unforeseen circumstances"

The IRS has issued four private rulings dealing with the "unforeseen circumstances" definition, granting relief in all four rulings, as follows:

- Relocation of taxpayers due to criminal activities in their neighborhood and assault and threats on their son (PLR 200601099).
- Inability of taxpayers to provide transportation for a younger child to attend school in the same school district as the child attended prior to their move; taxpayers intended to return to the same house but were unable to do so because the house was too small for their family (PLR 200601022).
- Taxpayers required to move due to age restrictions in their housing development because their daughter and grandchild moved in with them due to daughter's loss of job and pending divorce (PLR 200601023).
- Taxpayers required to move to a larger home to accommodate needs of a newly adopted child (PLR 200613009).

Observation
The IRS continues to issue taxpayer-friendly rulings dealing with the "unforeseen circumstances" definition. However, taxpayers should be reminded that they cannot generally rely on these private rulings; rather, a private ruling request for a specific taxpayer is required to meet the unforeseen circumstances definition, other than in instances where the IRS issues general rulings on the matter.

2.5 Taxability of State Income Tax Refunds

2.5.1 Background

Starting in 2004, individual taxpayers are allowed to deduct state and local sales taxes in lieu of state and local income taxes. Under the so-called tax benefit rule of Section 111, a state income tax refund is only taxable to the extent that payment of the state income taxes in the prior year produced a tax benefit for the taxpayer. Accordingly, taxpayers using the standard deduction in a prior year would not be taxed on any state income tax refund, because no benefit was received from deducting the state income tax.

2.5.2 Application of tax benefit rule expanded

Because of the statutory change starting in 2004 to deduct either sales tax or income tax as an itemized deduction on Schedule A, the IRS has revised its approach in calculating the tax benefit associated with refunds of state income tax. In its guidance, the IRS notes that a prior year state income tax refund received in the current year is only taxable to the extent the prior year state income tax deduction exceeded the deduction for state and local general sales tax that could have been claimed (IRS Pub. 525, *Taxable and Nontaxable Income: Miscellaneous Income*).

> *Example.* Kris deducted $13,000 of state income tax on her 2004 Form 1040. Had Kris deducted sales tax, the amount would have only been $10,000. Kris receives a $4,000 refund on her 2004 Form 1040. Kris needs only to report $3,000 of the state income tax refund as taxable income on her 2005 Form 1040, representing the excess of the actual state income tax deduction ($13,000) over what the sales tax deduction would have been ($10,000).

Practice Tip
Practitioners should be sure to enter all relevant sales tax information, such as sales tax paid on large purchases in completing the current year's Form 1040, even though the state income tax deduction may be

used. In this manner, the tax preparation software can properly compute the taxability of any refund amount received in the following year.

2.6 Employee Incentives to Purchase Environmentally Friendly Hybrid Automobiles

The IRS has issued guidance taking the position that cash incentives from employers to employees to encourage employees to purchase environmentally friendly hybrid automobiles represent taxable compensation to the employees, subject to payroll tax and federal withholding (IR-2006-112). The IRS determined that the payments were not excludable under the non-taxable fringe-benefit rules dealing with employee discounts at Section 132, but rather that they represented compensation to the employees, similar to other wage amounts.

2.7 Conservation Subsidies and Capital Improvements

2.7.1 Background

Section 126 provides for a tax-free exclusion of income for payments received under a variety of conservation programs. In the past, the IRS has issued guidance indicating that an increasing number of federal agricultural program payments may qualify for the cost-sharing privilege of Section 126. As an example, in Rev. Rul. 2003-14 (2003-1 CB 302), the IRS indicated that subsidies received under the Soil and Water Conservation Assistance Program could qualify. Similarly, in Rev. Rul. 2003-15 (2003-1 CB 302), the IRS indicated that payments received under the Agricultural Management Assistance Program could qualify.

The Secretary of Agriculture, in mid-2005, issued guidance involving payments under the Conservation Security Program. This program involves a variety of payments, with some payments associated with traditional cost-share reimbursements on conservation improvements and other payments involving what are known as stewardship programs, essentially rewarding a farmer for conservation activities such as crop rotation, tillage patterns, etc., considered to be "best practices." In the guidance, the Secretary of Agriculture indicated that payments received under the Conservation Security Program could qualify for the cost-sharing privilege of Section 126.

2.7.2 Capital improvements required for tax-free exclusion

In the statute itself, Section 126 does not specifically require that expenditures involve a capital improvement to qualify for the tax-free cost-sharing privilege. Rather, Section 126 simply specifies that a tax-free subsidy does not include the portion of any payment associated with an amount allowable as a current deduction [§126(b)(2)]. However, Temp. Reg. Section 16A.126-1(a) appears to clearly require capital improvements for payments to meet the tax-free exclusion of income privilege. Also, a previous Tax Court case held that payments received under a federal Water Bank Program were taxable to the recipient because no capital improvements had been made by the taxpayer (*Graves*, 89 TC 49, 1987). The court made it clear in this ruling that the tax-free exclusion only applies to amounts received for capital improvements, not to other income amounts paid to the taxpayer.

2.7.3 Applicability to conservation security program payments

Conservation Security Program payments associated with a capital improvement should meet the tax-free cost-sharing privilege of Section 126. However, Conservation Security Program payments that reward the recipient for tillage patterns and cropping practices, for example, which are unrelated to any capital improvement, represent taxable income to the recipient.

2.8 Personal Injury Statute Ruled Unconstitutional

2.8.1 Background

Section 104(a)(2) provides for tax-free receipt of funds paid to a taxpayer as a result of personal physical injury or physical sickness. However, the tax-free privilege of Section 104 extends neither to punitive damages, nor to nonphysical injuries, such as emotional distress awards or other awards for humiliation or loss of reputation.

2.8.2 Taxation of awards for nonphysical injuries ruled unconstitutional

The Court of Appeals for the District of Columbia Circuit has reversed a prior federal District Court decision, holding that the taxation of awards received for nonphysical injuries such as emotional distress, humiliation, and loss of reputation violates the Sixteenth Amendment

of the Constitution (*Murphy*, CA-DC, 8/24/2006). Under the Sixteenth Amendment, Congress has the power to collect taxes "on income, from whatever sources derived." However, the appellate court ruled that awards for damages such as emotional distress or loss of reputation represented a return of capital and accordingly, not income under the Sixteenth Amendment. The taxpayer argued at the appellate level that the amount should not represent taxable income, because the damage award was payment for the loss of a personal attribute of a "human capital." The court accepted this argument in ruling the personal injury statute of Section 104 unconstitutional.

Observation

Extreme caution should be exercised in following this decision, which is currently only directly applicable to the appellate circuit covering the District of Columbia.

2.9 Basis Recovery on Contingent Installment Sales

2.9.1 Background

Generally, the recovery of basis on an installment sale occurs pro-rata as the collections on the contract amount are received. However, many business sales include "earn out" terms, under which the total contract price is contingent on the subsequent performance of the business.

IRS regulations define the methodology for recovery of basis on a "contingent payment sale," providing that if a maximum selling price cannot be determined, but the maximum number of years over which payments are received is fixed, the basis is allocated to the taxable years in which payment is made in equal annual increments [Temp. Reg. §15a.453-1(c)(3)(i)].

However, taxpayers are allowed to use an alternative method of basis recovery if the taxpayers can demonstrate, prior to the timely filing of the tax return for the year of sale, that the normal basis recovery rules would substantially and inappropriately defer recovery of basis. A ruling request to use the alternative method of basis recovery must be filed by the due date, including extensions, of the tax return for the year in which the first payment is received [Temp. Reg. §15(a).453-1(c)(7)(ii)].

2.9.2 Alternative basis recovery method approved by IRS

In a private ruling, the IRS approved an alternative method of basis recovery for individuals who sold stock in their S corporation under

the installment method, but subject to a contingent payment schedule (PLR 20060317).

Under the terms of the stock purchase agreement, the shareholders were to receive a payment in the year of sale and on the following two anniversaries. After that period, they would receive a percentage of the annual operating income of the corporation in excess of a specified amount, with no maximum amount on the selling price. The shareholders proposed an alternative basis recovery method that would allocate the stock basis in proportion to the estimated amount of aggregate payments to be received, with the estimate based on the recent rate of return earned by the buyer's parent company on the carrying value of its investments, as well as on the prior earnings history, business, and business cycle of the S corporation.

The IRS approved the ruling request, allowing an alternative method of basis recovery at a rate more than twice as fast as the normal pro-rata basis recovery method.

2.10 Tobacco Program Buyouts

2.10.1 Background

Congress terminated the tobacco marketing quota program and the tobacco price support program in the American Jobs Creation Act of 2004. To provide compensation to affected taxpayers, the United States Department of Agriculture issued contracts to eligible tobacco quota holders and growers, authorizing payments to these taxpayers in 10 equal annual installments in fiscal years 2005 through 2014.

2.10.2 Tobacco quota holders

The IRS has issued guidance that tobacco quota holders who used the quota in farming and held the quota for more than one year are allowed to report the payments under Section 1231 (IRS Notice 2005-57, IRB No. 2005-57). Under Section 1231, gains result in long-term capital gain treatment, but losses receive ordinary loss treatment. The IRS clarified that the tobacco quota holders are eligible for installment treatment, even though they receive a Form 1099-S in the year of sale for the entire 10-year payment amount. This allows the taxpayers to only report gain based on the payment received during that year. For payments exceeding $3,000, the taxpayer is required to report a portion of the proceeds as interest income, but the payments are not subject to self-employment tax, nor are the payments eligible for farm income averaging because they are considered payments for an interest in land.

2.10.3 Tobacco growers

Payments to tobacco growers are determined by reference to the production or planting of tobacco of the grower during the 2002, 2003, and 2004 tobacco marketing years. Payments of up to $3 per pound of quota are paid to tobacco growers in 10 equal annual payments in fiscal years 2005 through 2014. Regarding payments to tobacco growers, the IRS indicated that future guidance would clarify the tax treatment of these payments.

3. INDIVIDUAL DEDUCTION DEVELOPMENTS

3.1 Hobby Losses

3.1.1 Background

An activity is considered engaged in for profit if it is of the kind that would support a deduction for a business expense, for an expense for the production or collection of income, or the management, conservation, or maintenance of income-producing property [§183(c)].

Relevant Factors. In determining if an activity is carried on for profit, all the relevant facts are taken into account. No one factor alone is decisive [Reg. §1.183-2(b)]. Among the factors to be considered are:

1. If the activity is carried on in a businesslike way.
2. If the time and effort put into the activity indicate intention to make it profitable.
3. If the taxpayer is depending on income from the activity for his or her livelihood.
4. If the taxpayer's losses from the activity are due to circumstances beyond control (or are normal in the start-up phase of the taxpayer's type of business).
5. If the taxpayer changes methods of operations in an attempt to improve the activity's profitability.
6. If the taxpayer or advisers have the knowledge needed to carry on the activity as a successful business.
7. If the taxpayer has been successful in making a profit in similar activities in the past.
8. If the activity makes a profit in some years, and how much profit it makes.
9. If the taxpayer can expect to make a future profit from the appreciation of assets used in the activity.

Judicial Determinations
In determining whether a particular activity was conducted with the requisite profit motive, the courts will apply the preceding tests to the facts and circumstances of the particular taxpayer's business activity.

3.1.2 Family farm deemed to be hobby

A family farm operated by a practicing attorney/CPA who worked over 3,000 hours per year in his professional practice was found to be subject to the hobby loss rules (*Mitchell v. Comm.*, TC Memo 2006-145, 7/6/2006).

3.2 Passive Loss Developments

3.2.1 Background

The passive activity rules apply to (1) individuals; (2) estates; (3) trusts (other than grantor trusts); (4) personal service corporations; and (5) closely held corporations [§469(a)]. The intent of the passive loss rules is to prevent the current deductibility of any passive losses or passive activity credits against the other income of a taxpayer. Net passive losses and passive credits are suspended, and carry forward to offset future passive income, or eventually to be claimed upon disposition of the passive activity.

In general, passive activities fall into two categories:

- A business activity in which the taxpayer does not materially participate, and
- Any rental activity [§469(c)].

Special exceptions exist which allow losses from working interests in oil or gas property held directly by the taxpayer or through an entity that does not limit the liability of the taxpayer. Also, limited losses may be claimed on rental real estate activities (although subject to an AGI phaseout) and for real property businesses conducted by real estate professionals.

3.2.2 Material participation

With respect to a business activity, a taxpayer can avoid passive activity status by materially participating in the trade or business. The opportunity to materially participate to avoid passive loss status only applies to business activities, not rental activities (other than for qualifying real estate professionals). An individual materially participates in an activity if the taxpayer's participation meets *one* of the following tests [Reg. §1.469-5T(a)]. A taxpayer is a material participant if:

1. The taxpayer participates in the activity for over 500 hours during the year (including as a limited partner).
2. The taxpayer's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including nonowners) for such year.
3. The taxpayer participates for over 100 hours during the year and no other individual has greater participation.
4. The activity is a significant participation activity (over 100 hours per year) and the sum of the taxpayer's significant participation activities exceeds 500 hours during the year.
5. The taxpayer materially participates in the activity for any five of the immediately preceding 10 taxable years (including as a limited partner).
6. The taxpayer materially participated in a personal service activity (that is, in the fields of law, health, engineering, architecture, accounting, actuarial science, performing arts, or consulting, or in any other trade or business where capital is not a material income-producing factor) for any three taxable years (whether or not consecutive) preceding the taxable year (including as a limited partner).
7. Based on all the facts and circumstances, the taxpayer participates in the activity on a regular, continuous and substantial basis. A taxpayer cannot satisfy this "facts and circumstances test" if he or she does not participate for over 100 hours in the year.

Participation includes work done by an owner as an employee (except through a C corporation) in connection with the activity in which he or she owns an interest. But work not customarily done by an owner, one of the principal purposes of which is to avoid a Section 469 disallowance, or work done by an individual in his capacity as an investor, is not considered [Reg. §1.469-5T(f)].

Spousal Aggregation. In determining whether a taxpayer materially participates, the participation of the spouse of the taxpayer is taken into account in meeting the tests [§469(h)(5)].

> *Example.* Sam and Sue, husband and wife, are each a 50 percent stockholder in an S corporation conducting an active retail business. However, Sam spends only about 100 hours per year, whereas Sue works full-time, in the retail activity of the S corporation. Sue's material participation will extend to Sam under the spousal rule, and both will be considered material participants for purposes of avoiding the passive loss restrictions.

3.2.3 Rental activities

A rental activity is automatically a passive activity, even if a taxpayer materially participates in that activity. An activity is a rental activity if

tangible property (real or personal) is used by customers or held for use by customers, and the gross income (or expected gross income) from the activity represents amounts paid (or to be paid) mainly for the property's use. It does not matter whether the use is under a lease, a service contract, or some other arrangement.

Exceptions to Rental Status. The taxpayer's activity is not a rental activity if any of the following apply [Reg. §1.469-1T(e)(3)(ii)]:

1. Each customer uses the property for an average of seven days or less (for example, car rental businesses, tuxedo rentals).
2. Each customer uses the property for over seven days but not over 30 days and "significant" personal services are provided by or on behalf of the owner (for example, operating a hotel). Routine services commonly provided in long-term rentals (for example, collecting garbage, routine repairs, and doorman) are not significant services.
3. Extraordinary personal services are provided by individuals by or on behalf of the property's owner in connection with the rental (for example, a hospital).
   Note: In PLR 9247003, the IRS held that the management and operation of retirement centers are not rental activities. The residents' monthly payments were more than twice the cost of a luxury apartment, and the IRS concluded that a center's income was principally for the services provided (for example, meals, laundry and maid service, utilities) rather than for the use of the tangible property.
4. Rental of the property is treated as incidental to an investment in the property where (a) the owner seeks gain by increase in value and the gross rent is under 2 percent of the lesser of the property's market value or basis, or (b) the property is used in a trade or business and the rent is under 2 percent of the property's value or basis, or (c) the property is held for sale and is sold during the year, or (d) the property is used as lodging for the taxpayer's employees for the taxpayer's convenience.
5. The property is made available during defined business hours for nonexclusive use by various customers (for example, a public golf course), or
6. The property is used in a nonrental activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest.

Observation

The consequence of most of these exceptions to rental status is that the activity is treated as a business activity (for example, a building with short-term rentals of seven days or less is treated as a hotel-type business

activity rather than rental real estate). When an activity is categorized as a business activity, the taxpayer may meet one of the material participation tests to avoid passive status.

Caution

The first of the six exceptions to rental status listed above (that is, average tenant use of seven days or less) has been used aggressively by the IRS to disallow rental losses on vacation properties such as ski condos or waterfront villas, where the average tenant stay is often under one week. The IRS uses the exception in the regulations to reclassify the property from rental status to business status. In rental status, the owner is often able to claim the $25,000 rental real estate loss privilege. However, when the property is reclassified to business status, the owner normally is unable to meet any of the material participation tests, and all losses are suspended under Section 469 (*Madler*, TC Memo 1998-112; *Pohaski*, TC Memo 1998-17; *Rapp*, TC Memo 1999-249; *Lapid*, TC Memo 2004-222).

3.2.4 Guidance issued on airplane leases

IRS guidance has been issued on two specific situations involving the lease of an airplane to a related closely held entity (Rev. Rul. 2005-64, IRB No. 2005-39). One situation involves an airplane lease with no services provided and the other an airplane lease with significant personal services provided.

3.3 Like-Kind Exchanges

3.3.1 Background

Like-kind exchanges are a way to avoid (defer) taxable gain (and depreciation recapture) when switching business or investment property. Though such exchanges are common (as trade-ins) for machinery and vehicles, they are also frequently used for real property. The tax deferment of like-kind exchanges under Section 1031 is mandatory, not elective.

As with other nonrecognition provisions in the Code, the consequence is that the adjusted basis of the traded asset carries over to become the basis of the acquired asset. This carryover basis is increased for any boot paid and for any net increase in debt. On the other hand, to the extent boot is received or net liabilities of the exchangor are decreased, gain recognition occurs. Basis is increased for gain recognized, and decreased for boot received and net debt relief [Reg. §1.1031(d)-1 and -2].

IRS Form 8824, *Like-Kind Exchanges*, is used to report like-kind exchanges. This form calculates any recognized gain, as well as the basis of property received.

3.3.2 Determining like-kind product classes

The IRS has issued final regulations replacing the use of the Standard Industrial Classification (SIC) system with the North American Industry Classification System (NAICS) for determining when tangible personalty is within the same product class for purposes of the like-kind exchange rules of Section 1031. Under these regulations, depreciable tangible personal property is considered like-kind in an exchange if it is described in the same six-digit product class within Sectors 31, 32, and 33 of the NAICS codes. These regulations apply to transfers of property after August 12, 2005 [Reg. §1.1031(a)-2(b)(3), T.D. 9202, 5/19/2005].

Example. Linda, who operates a proprietorship business, exchanges a used personal computer (asset class 00.12) for a new printer (asset class 00.12). The properties exchanged are within the same General Asset Class and therefore qualify as like-kind properties for a Section 1031 exchange.

Example. Glen, who operates a road construction business, exchanges a grader for a scraper. Neither property is within any of the general asset classes, but both properties are within the same Product Class (NAICS Code 333120). Accordingly, Glen has exchanged like-kind properties within the same Product Class that are eligible for Section 1031 treatment.

3.3.3 Trademarks and trade names not like-kind

The IRS has issued a private ruling, denying like-kind treatment on the exchange of patents, trademarks, and other intangible property (TAM 200602034).

The IRS noted that because asset classes are not provided for intangible properties, like-kind treatment is only achieved on the exchange of intangible property if the matching of the nature or character of the rights involved are like-kind and the nature or character of the underlying property to which the intangible personal property relates is like-kind.

While the IRS found that the nature or character of rights of one patent is generally identical to the nature or character of rights of a different patent, the nature or character of the underlying property to which the intangible personal property relates is not like-kind. Similarly, the IRS determined that trademarks and tradenames are not alike and should not be considered like-kind property for purposes of Section 1031.

3.4 Alimony

3.4.1 Background

Payments properly classified as alimony are deducted above the line on the payor's tax return. For a payment to be classified as alimony and thus deductible by the payor and includable as income by the recipient, it must be made under a written divorce or separation instrument and meet all of the following requirements (§71(b)):

1. The payment must be in cash.
2. The payor's obligation to make payments must be relieved upon the recipient's death.
3. When the payment is made, the payor and payee cannot be members of the same household.
4. The divorce or separation instrument does not designate the payment as not includable in gross income of the recipient and not allowable as a deduction to the taxpayer.
5. The payment cannot be explicit or disguised child support.

3.4.2 Transfer of note receivable

The Tax Court determined that the transfer of a note receivable by a taxpayer to his ex-spouse did not qualify as alimony because it was not in the form of cash or a cash equivalent (*Lofstrom v. Comm.*, 125 TC No. 13, 11/22/2005).

To settle an arrearage on alimony payments, the taxpayer agreed with his ex-spouse that he would assign his interest in a contract for deed, along with a small amount of cash. However, looking directly to the statute of Section 71(b)(1), the court noted that that alimony must be in the form of cash or a cash equivalent and that the transfer of the debt instrument did not satisfy this requirement.

Observation

Additionally, Section 71(b)(1)(D) requires alimony payments to terminate upon the death of the recipient taxpayer. Because the payments on the debt instrument would survive the death of the recipient, the transfer of the note receivable failed to qualify as alimony under this test as well.

3.5 Self-Employed Health Insurance Deduction

3.5.1 Background

Under Section 162(l)(1)(A), a self-employed individual is allowed to deduct 100 percent of insurance premiums for medical care of the

taxpayer and the taxpayer's spouse and dependents. However, the deduction is limited to the earned income of the taxpayer derived from the business with respect to which the plan providing the medical care coverage is established. Taxpayers are not entitled to the self-employed health insurance deduction during any month in which the taxpayer is eligible to participate in a subsidized health plan maintained by an employer of the taxpayer or an employer of the spouse of the taxpayer.

3.5.2 IRS guidance on ownership of policy

The Chief Counsel's Office has issued an advisory memorandum clarifying that a Schedule C or Schedule F sole proprietor may use the 100 percent self-employed health insurance deduction to claim family insurance costs, even when the health insurance policy purchased by the proprietor is issued in the individual name of the proprietor rather than the name of the proprietor's business (CCA 200524001). In this determination, the IRS concluded that a proprietor purchasing health insurance in his or her individual name met the requirement to establish a plan providing medical coverage with respect to the business.

3.5.3 Aggregation of business income not allowed

In the same advisory memorandum (CCA 200524001), the IRS made it clear that a self-employed individual cannot aggregate profits from multiple businesses for purposes of determining the deduction limit for the self-employed health insurance deduction. When more than one business exists, the taxpayer may deduct the medical care cost of each specific health insurance plan established for each specific business, limited by the net earnings of the specific business. Income from multiple businesses may not be aggregated with respect to a single health insurance policy.

3.5.4 Self-employment income not reduced by self-employed insurance costs

The Chief Counsel's Office clarified in a separate advice memorandum that a self-employed sole proprietor is unable to deduct health insurance costs on Schedule C or Schedule F, but can only claim the deduction as an adjustment to income on page 1 of Form 1040 (CCA 200623001).

Observation

Although unable to deduct health insurance costs for self-employment purposes, these taxpayers may be able to establish a fringe benefit plan in the case of a spousal employment arrangement whereby the insurance is provided to the spouse as a tax-free fringe benefit, deductible to the employer-spouse on Schedule C or Schedule F.

3.6 Itemized Deductions: Charitable Contributions

3.6.1 Background

A charitable deduction for larger contributions made by an individual or partnership will not be allowed unless the donor complies with substantiation requirements.

Contributions of $250 or more are deductible only if substantiated by a contemporaneous written acknowledgment from the donee charity. The acknowledgment must include the amount of cash and a description of any other property contributed, whether the donee provided any goods or services in consideration of the contribution, and a description and estimate of the value of the goods and services, if any, or a statement that the goods and services consist solely of "intangible religious benefits" (for example, admission to a religious ceremony) [§170(f)(8); Reg. §1.170A-13(f)].

Caution

In two Tax Court Summary opinions, taxpayers were denied deductibility of charitable contributions for failure to retain records substantiating alleged cash contributions made to charities. In one case, the taxpayer had no records to substantiate over $8,000 of alleged cash contributions to his church over a two-year period, claiming that the records were in the possession of his former spouse. However, the taxpayer gave no explanation as to why he was unable to recover the records from his ex-wife (*Ekeh v. Comm.*, TC Summary Opinion 2001-50, 4/5/2001). The other ruling involved a couple unable to substantiate most of their cash contributions allegedly made to a church. Also, additional contributions were disallowed for donations of cash and an automobile directly to the president of a charity, because the gifts had not been made directly to the charitable organization itself (*Barck, et ux. v. Comm.*, TC Summary Opinion 2001-51, 4/5/2001).

3.6.2 Substantiation of cash contributions

The Pension Protection Act of 2006 requires *all* contributions of cash, regardless of amount, to be substantiated via bank record (that is, cancelled check) or via written communication from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution, effective for contributions made in taxable years beginning after August 17, 2006.

Example. Dick and Jane regularly drop cash contributions in the collection basket while attending weekend church services near their lake home.

Effective in 2007, Dick and Jane either need to write a check to claim a charitable contribution or otherwise obtain a receipt from the church substantiating their contribution. No amount is allowed as a charitable deduction for cash amounts, starting in 2007 for calendar year taxpayers, unless proper substantiation exists.

3.6.3 Contributions of used clothing and household items

The Pension Protection Act of 2006 enacted another provision, disallowing any deduction for a charitable contribution of clothing and household items unless the clothing or household item is "in good used condition or better." Household items include furniture, furnishings, electronics, appliances, linens, and other similar items. Food, paintings, antiques, and other items of art, jewelry and gems, and collectibles are excluded. This provision is effective for contributions made after August 17, 2006.

3.6.4 Contributions of food inventory

The Pension Protection Act of 2006 has extended a provision originally enacted as part of the Katrina Emergency Tax Relief Act of 2005, providing an enhanced charitable write-off for the contribution of food inventory. The provision has been extended through 2007 and allows any taxpayer, whether or not a C corporation, engaged in a business to be eligible to claim the enhanced deduction for donations of food inventory for the care of the ill, the needy, or infants.

The enhanced charitable deduction amount equals the lesser of (1) basis plus one-half of the appreciation of the item, or (2) twice basis.

Limitations exist on the total deduction, with the deduction for taxpayers other than C corporations limited to 10 percent of the taxpayer's net income for the year from all proprietorships, S corporations, or partnerships from which contributions of food inventory were made.

3.6.5 Contributions of book inventory

The Pension Protection Act of 2006 has extended a provision originally enacted as part of the Katrina Emergency Tax Relief Act of 2005 related to the contribution of book inventories to a K-12 public school. The provision has been extended through the end of 2007, allowing the enhanced charitable contribution deduction, similar to the deduction described in Section 3.6.4, above. However, the enhanced charitable contribution deduction for book inventory is only available for C corporations and only for donations to K-12 public schools of books for use in their educational programs.

3.6.6 Contributions of fractional interests of tangible personal property

The Pension Protection Act of 2006 enacted a change limiting the amount of the charitable contribution deduction for fractional interest donations, while also providing rules for valuing additional fractional interest contributions made by the donor in the future. The fair market value of any additional contribution of a fractional interest is calculated as the lesser of (1) the fair market value of the property at the time of the initial fractional contribution, or (2) the fair market value of the property at the time of the additional contribution.

No charitable contribution deduction is allowed for a contribution of a fractional interest in an item of tangible personal property unless all interests in the item of tangible personal property were owned by the donor, or by the donor and donee, immediately before the contribution. The provision also provides for recapture of the charitable contribution deduction in certain circumstances, primarily when the donor fails to contribute all of the remaining interest in the property to the same donee before the earlier of 10 years from the initial fractional contribution or the date of death of the donor. The provision applies for contributions made after August 17, 2006.

3.6.7 Qualified conservation contributions

The Pension Protection Act of 2006 has increased the former 30 percent-of-AGI limitation that applied to qualified conservation contributions to a 50 percent-of-AGI limitation. Any excess qualified conservation contributions exceeding the 50 percent-of-AGI limit are eligible for a 15-year carryover. A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes.

A qualified real property interest is defined as:

- The entire interest of the donor other than a qualified general interest.
- A remainder interest.
- A restriction, granted in perpetuity, on the use that may be made of the real property.

3.6.7.1 Individual farmers and ranchers

A qualified farmer or rancher is entitled to an enhanced charitable contribution deduction for qualified conservation contributions, with such a taxpayer allowed to deduct these contributions up to 100 percent of the excess of the taxpayer's AGI over the amount of all other allowable charitable contributions.

Example. Larry is a qualified farmer with AGI of $100,000 who makes a qualified conservation contribution of agricultural property with a fair market value of $80,000. Larry also makes other cash contributions during the year of $60,000.

Larry is entitled to deduct $50,000 of the cash contributions, subject to the 50 percent-of-AGI limitation. Larry is then also allowed to deduct an additional $50,000 for the qualified conservation contribution. The $30,000 of excess qualified conservation contribution carries forward for up to 15 years, subject to the 100 percent-of-AGI limitation. The excess $10,000 cash contribution carries forward for five years.

3.6.7.2 Corporate farmers and ranchers

Corporations other than publicly traded corporations which are qualified farmers or ranchers are allowed to deduct a qualified conservation contribution up to 100 percent of the excess of the taxable income of the corporation over the amount of all other allowable charitable contributions. Excess qualified conservation contributions are carried forward for up to 15 years, subject to the 100 percent of taxable income limitation.

3.6.8 Contributions of taxidermy property

The Pension Protection Act of 2006 enacted a provision limiting the amount allowed as a charitable deduction to the lesser of the taxpayer's basis in the property or the fair market value of the property for contributions of taxidermy property contributed by the person who prepared, stuffed, or mounted the property, or by any person who paid or incurred such costs.

Taxidermy property is defined as any work of art that is the reproduction or preservation of an animal in whole or in part, is prepared, stuffed, or mounted for purposes of recreating one or more characteristics of such animal, and contains a part of the body of the dead animal.

The basis of the property may only include the cost of preparing, stuffing, or mounting the animal. Indirect costs are not included in basis, including the cost of transportation relating to any aspect of the taxidermy or the hunting of the animal, and the direct or indirect costs related to the hunting or killing of the animal. Similarly, the cost of equipment and the cost of preparing an animal carcass for taxidermy are not included in basis.

The provision applies to contributions made after July 25, 2006.

3.6.9 Charitable contributions of vehicles

Prior to 2005, a contribution of a used nonbusiness vehicle to charity was deducted at fair market value (FMV). In the case of a contribution after December 31, 2004, of a used vehicle, boat or airplane (other

than items held in inventory) for which the claimed charitable deduction exceeds $500, no deduction is allowed unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgment by the charity and includes that acknowledgment with the taxpayer's return for the year which includes the deduction. If the vehicle is sold by the charity without any significant intervening use or material improvement, the amount of the charitable deduction may not exceed the gross proceeds received by the charity from the sale [§170(f)(12)].

Written Acknowledgment by Charity. The taxpayer must substantiate the contribution of a vehicle, boat or airplane by a contemporaneous written acknowledgment from the charity that is attached to the return. If the vehicle is sold by the charity, the receipt must identify the gross proceeds from the sale and include a statement that the deduction may not exceed those gross proceeds.

There are three exceptions to the rule limiting the charitable deduction to the charity's sale price of the vehicle:

1. Significant intervening use by the charity (such as retaining the vehicle for driving required in the charity's exempt purpose).
2. Material improvements by the charity (such as in the case of a technical school that retains the vehicle for training and improvement by students).
3. The charity supplies the vehicle to a needy individual at no cost or at a price significantly below market value, but only if in direct furtherance of the charity's purpose of relieving the poor or underprivileged who are in need of transportation (IRS Notice 2005-44, IRB No. 2005-25).

In these cases, the receipt must identify the intended use or material improvement of the vehicle and the duration of such use, and also contain a certification by the charity that the vehicle will not be transferred for money or other property or service before completion of the use or improvement. In these cases, the charitable deduction is not limited to the gross sales proceeds, but instead can be established by a reasonable method, including the use of an established used car pricing guide. The charity must provide the written acknowledgment to the donor within 30 days of the sale of the vehicle or within 30 days of the contribution if the charity retains the vehicle for its use (§6720).

> *Example.* Bud donates a used vehicle to a charity, which immediately brokers the vehicle through a used car auction market and receives $4,800. The charity must provide a written acknowledgment to Bud that identifies the sales price and informs Bud that his charitable deduction may not exceed the gross sale price amount of $4,800. When preparing his tax return claiming the charitable deduction, Bud must attach the written acknowledgment received from the charity.

Example. Assume the same facts as in the preceding example, except that Bud donates the vehicle to a charity which retains the vehicle for use by its staff in the charity's exempt activities. In this case, the written acknowledgment from the charity must identify that it retained the vehicle for its use and the intended duration of such use, along with a certification by the charity that the vehicle would not be transferred for money or other property or services before completion of the use. In this case, the fair market value for calculation of Bud's charitable deduction may be determined by an established used car pricing guide.

Observation

In the case of business donations of depreciable property, the fair market value is generally not a determining factor in the charitable deduction. The fair market value is the starting point for the charitable contribution calculation, but that fair market value must be reduced by the ordinary income depreciation recapture that would have occurred if the asset had been sold for fair market value. The result generally is to limit the charitable contribution to the adjusted tax basis of the property in the case of a business vehicle donated to charity.

IRS Guidance. IRS Notice 2005-44 contains interim guidance regarding the substantiation and information reporting requirements for both the donor of the used vehicle and the charity (IRS Notice 2005-44, IRB No. 2005-25).

Form 1098-C. The IRS has issued Form 1098-C, *Contributions of Motor Vehicles, Boats, and Airplanes,* which charities are to use to report to the IRS and to the donor with respect to contributions of motor vehicles, boats, or airplanes having a value of more than $500. Copy A of the form is to be furnished to the IRS, and the charities are to provide donors with Copies B and C of Form 1098-C. Copy B is to be attached by the donor to the federal tax return, in order to support the donor's deduction for the contribution. The information in box 4 of the Form 1098-C is completed by the charity if the vehicle was sold (that is, contains the date of sale and gross proceeds from the sale), whereas information in box 5 is to be completed by the charity if the charity has retained the vehicle for significant intervening use, made material improvements to the vehicle, or transferred the vehicle to a needy individual for significantly below market value in furtherance of the charity's exempt purpose.

3.6.10 IRS revises Form 1098-C

The IRS has now issued a revised version of Form 1098-C, allowing the form to be used to meet the contemporaneous written acknowledgment rules of Section 170(f)(8) even when the fair market value of the vehicle is under $500.

Additionally, the revised Form 1098-C implements changes enacted by the Gulf Opportunity Zone Act of 2005, which requires the donor acknowledgement to indicate whether the donee organization provided goods or services in consideration of the vehicle, and also requires the donee organization to describe any goods or services provided, along with an estimate of the fair market value of such goods and services.

3.6.11 Charitable contribution for pleasure travel

In a Small Tax Case Division opinion, the court denied a charitable contribution for a taxpayer who encountered approximately $1,500 of expenses in accompanying the Houston Symphony Chorus on a tour of England and Wales (*Field v. Comm.*, TC Summary Opinion 2005-184, 12/20/2005).

In reviewing the itinerary of the trip, the court found that the majority of the time related to sightseeing rather than efforts that would relate to the charitable cause itself (that is, volunteer efforts related to the Houston Symphony).

Observation

Direct expenses paid by a taxpayer related to charitable organizations are deductible as a charitable contribution. As an example, a taxpayer who might pay airfare and other direct expenses to attend a Board meeting of a charitable organization would be allowed to deduct such expenses as a charitable contribution. However, in this case, the court found that the personal pleasure element of the travel far exceeded any relationship of the costs to the efforts of the charitable organization and thus denied charitable contribution deductibility.

3.6.12 Payments to religious school

The Tax Court has denied a charitable contribution to a couple for amounts paid to a religious school for tuition and fees paid for the couple's children to attend the school (*Sklar v. Comm.*, 125 TC No. 14, 12/21/2005).

The couple had paid approximately $27,000 in tuition and fees for their children to attend the school and attempted to deduct $15,000 of the amount as a charitable contribution, using the argument that the education received was an "intangible religious benefit."

However, the court noted that a charitable intent must exist for a charitable contribution to be deductible, and the court found no such intent in this case.

3.7 Accountable Plans

3.7.1 Background

There are three requirements to meet the accountable plan rules [§62(c); Reg. §1.62-2(c)]:

- The plan must reimburse employees for business expenses that would be deductible if the employer paid the expenses directly.
- The plan must require substantiation to be completed by the employee of the business nature of each expense, and, if applicable, require additional documentation for travel and entertainment items.
- The plan must require the employee to return any portion of an allowance or advance which exceeds the actual expenditures substantiated by the employee.

If an employer reimbursement arrangement meets the above criteria, the employer is able to deduct all reimbursements made the employee, subject to the 50 percent disallowance for meal and entertainment expenses. The employee needs include none of the reimbursement in income and no payroll taxes attach to the payments.

3.7.2 Accountable plan requirements not met

The Eighth Appellate Circuit has upheld a Tax Court decision, finding that employer reimbursements did not meet the accountable plan criteria, thus requiring the reimbursements to be included in the compensation of the employees (*Namyst*, CA-8, 1/27/2006).

The employer established a reimbursement arrangement for payments to employees for tools. However, when the employees turned in amounts to the employer for reimbursement, amounts were paid in whole dollars and did not necessarily correlate to the actual expenses of the employees. Additionally, excess payments were made to the employees, which were not returned to the employer. The employer attempted to argue that the amounts actually substantiated should fall under the accountable plan rules, with only unsubstantiated amounts being required to be included in employee income. The courts rejected this argument, noting that it would effectively render the third requirement of the accountable plan rules moot.

3.8 Employee Use of Personal Vehicle

In a Small Tax Case Division opinion, the court denied a business deduction on Schedule C for an employee's use of his personal vehicle

in employment matters (*Alley v. Comm.*, TC Summary Opinion 2006-4, 1/19/2006).

The employee used his personal vehicle for business matters of his employer, receiving $3,375 of mileage reimbursement from his employer. The employee reported this amount as gross receipts on Schedule C and then deducted his actual automobile expenses, totaling approximately $16,000, as expenses on Schedule C. The taxpayer labeled the Schedule C business as being one of "Leasing Cars."

The court found the taxpayer was not in the business of "leasing cars" and denied the Schedule C deduction. However, the court did note that the taxpayer could properly deduct the difference between the reimbursements received and his actual vehicle expenses as an employee business expense on Schedule A as a miscellaneous itemized deduction.

Observation

Deducting the amount as a miscellaneous itemized deduction would both subject the deduction to the 2 percent of AGI offset and also potentially expose the taxpayer to the alternative minimum tax, because miscellaneous itemized deductions are not deductible for alternative minimum tax purposes.

4. RETIREMENT PLAN ISSUES

4.1 Roth IRA Conversions

4.1.1 Background

Taxpayers are allowed to make contributions to either traditional IRAs or Roth IRAs. Limitations exist on contributions to Roth IRAs, based on the adjusted gross income of the taxpayer. The maximum Roth IRA contribution amount is phased out at adjusted gross income between $150,000 to $160,000 on a joint return and $95,000 to $105,000 in all other cases, other than married individuals filing separately.

Taxpayers with adjusted gross income of $100,000 or less may convert all or a portion of a traditional IRA to a Roth IRA. While the amount represents taxable income, it is not subject to the 10 percent premature distribution penalty.

4.1.2 AGI conversion limit eliminated starting in 2010

The Tax Increase Prevention and Reconciliation Act has eliminated the AGI income limitation on Roth conversions, starting in 2010. Any

amounts converted in 2010 from a traditional IRA to a Roth IRA are granted a two-year forward spread of income, with one-half of the amount to be reported in 2011 and the other one-half of the amount to be reported in 2012. This two-year spread of income is only available for a conversion in 2010. Taxpayers may elect not to have the two-year spread apply, in which case the entire conversion amount needs to be included in year 2010 income.

Observation

The current contribution limits to Roth IRAs are effectively negated by this provision. Regardless of AGI, taxpayers are able to make a contribution to a nondeductible traditional IRA, even in instances in which they are an active participant in a retirement plan, followed by a rollover (starting in 2010) of the traditional nondeductible IRA to a Roth IRA. Such a conversion will prove particularly attractive to taxpayers who expect to be in a higher tax bracket during their retirement years and also those taxpayers who wish to avoid the minimum distribution rules that apply to traditional IRAs.

Various restrictions apply, including a restriction preventing taxpayers from receiving premature distributions from a Roth IRA while the benefit of the two-year income spread applies. Individuals who die prior to reporting the entire amount of income from the two-year spread in 2011 and 2012 are required to bring any remaining income amount into the Form 1040 in the year of death.

4.2 IRA Compensation Includes Combat Pay

4.2.1 Background

Taxpayers are allowed to contribute amounts to an IRA, subject to limitations, up to 100 percent of taxable compensation. Under Section 112, combat-zone compensation is excluded from taxable income, limited to the maximum enlisted amount for commissioned officers.

Accordingly, excluded combat pay under Section 112 could not be used as compensation for purposes of an IRA contribution.

4.2.2 Combat pay allowed as compensation for IRA purposes

Combat pay excluded from income is treated as compensation for purposes of allowable IRA contribution purposes [Heroes Earned Retirement Opportunity Act, P.L. 109-227, amending §219(f)(7)].

The legislation allows a special three-year window for making retroactive IRA contributions based on excludable combat pay for taxable years 2004 and 2005, also allowing affected taxpayer to make a spousal IRA contribution for those years.

Observation
Effectively, individuals who receive nontaxable combat pay in 2004 or 2005 have until May 28, 2009, to amend their return and make an IRA contribution for either or both of those years.

Because the rules for Roth IRA contributions are tied to the traditional IRA rules, the new legislation applies for purposes of both Roth IRAs and traditional IRAs.

Observation
Congress previously enacted a similar provision related to the earned income credit, allowing excludable combat pay to be treated as earned income for purposes of computing the earned income credit. Taxpayers are allowed to elect to treat combat pay as earned income for purposes of the earned income credit (EIC), although this election is scheduled to expire at the end of 2006.

4.3 Permanent Enactment of Retirement Plan Provisions of 2001 Tax Act

4.3.1 Background

The Economic Growth and Tax Relief Reconciliation Act of 2001 made a number of changes to provisions of the Code associated with pensions and IRAs. However, because of the sunset provision of the 2001 Act, all the provisions were scheduled to expire at the end of 2010.

4.3.2 Pension and IRA provisions made permanent

The Pension Protection Act of 2006 has made all the retirement plan provisions enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 permanent by repealing the sunset provision of that Act that applied to pension and IRA issues.

In total, there were almost 40 provisions originally enacted by the Economic Growth and Tax Relief Reconciliation Act of 2001 made permanent by the Pension Protection Act of 2006. The following represents a partial list of some of the more important provisions:

- Increases in the IRA contribution limits, including the age 50 or over catch-up provision

- Deemed IRAs under employer plans
- Increases in the limits of contributions, benefits, and compensation under qualified retirement plans, tax-sheltered annuities, and eligible deferred compensation plans
- Application of the prohibited transaction rules to plan loans of S corporation owners, partners, and sole proprietors
- Elective deferrals not taken into account for purposes of deduction limits
- Modifications to deduction limits
- Option to treat elective deferrals as Roth contributions
- Credit for pension plan start-up costs
- Catch-up contributions for individuals age 50 and older to 401(k), 403(b), 457, SARSEP, and SIMPLE plans
- Faster vesting of employer matching contributions
- Increased portability in rollovers of retirement plan and IRA distributions

A complete list of the provisions made permanent by the Pension Protection Act of 2006 can be obtained by reviewing the Conference Committee Report to Section 811 of the Pension Protection Act.

4.4 IRA Transfers in a Tax-free Manner to Charity

4.4.1 Background

Taxpayers wishing to make charitable contributions with IRA proceeds were required to include the taxable portion of a withdrawal from a traditional or Roth IRA in income and then take a charitable contribution deduction, subject to the normal applicable limitations on deductibility, including the barrier of exceeding the standard deduction, on such contributions.

Because these taxpayers were required to take the IRA withdrawal amount into income, additional income was often triggered under the formula taxing Social Security benefits, along with the phase-in and phase-out of other amounts based on AGI.

4.4.2 Eligible taxpayers can use tax-free IRA transfers to charity

The Pension Protection Act of 2006 made a change allowing distributions made in taxable years beginning after December 31, 2005, and before January 1, 2008, to be directly transferred to a qualified charity

for eligible taxpayers age 70½ or older. This allows the amounts to bypass income recognition on the IRA distribution. However, the IRA funds must be moved directly to a qualified charity by the IRA trustee. Not all charities are eligible; private foundations and donor advised funds are not allowed as qualified charities.

Distributions directed to the charity count toward the minimum required distribution requirement of the taxpayer, thus allowing some taxpayers to avoid minimum required distribution income amounts using this method. Additionally, by reducing the IRA balance via the contribution feature, minimum required distribution amounts will be minimized or possibly even eliminated in the future and income-in-respect-of-a-decedent amounts will be minimized for the IRA beneficiaries.

Amounts directed to charity are deemed to come from income amounts first and from basis second, with a charitable contribution deduction only allowed on amounts taken from basis. No charitable contribution deduction is allowed for the income portion of the distribution that avoids taxation. For purposes of determining the amounts from income and basis, all IRAs of the taxpayer are aggregated.

> *Example.* Lois has a current Roth IRA balance of $50,000, of which $40,000 represents income and $10,000 represents basis. Lois transfers $40,000 of the Roth IRA directly to charity, resulting in the recognition of no income by Lois. However, because the amount is deemed to come entirely from income, no charitable contribution is allowed on the transfer of the Roth IRA to charity.

Any IRA distributions directed to charity are limited to a maximum of $100,000 per year. While the contributions are not subject to the normal charitable contribution percentage limitations, any deductible charitable contributions require the normal written acknowledgment and are subject to the quid pro quo rules that normally apply. The privilege only applies to IRAs and does not extend to SIMPLE IRAs or SEPs.

Practitioners will need to be proactive regarding this provision and be in contact with qualifying clients. Because the provision is retroactively effective to January 1, 2006, and provides potential huge opportunities for many taxpayers, contact with clients will need to occur.

4.5 Expanded Rollover Opportunities for IRAs and Pension Plans

4.5.1 Background

Only taxpayers with modified AGI of $100,000 or less are allowed to roll over amounts from a traditional IRA into a Roth IRA. Additionally,

amounts that have been distributed from a tax-qualified retirement plan, a 403(b) annuity, or a 457 plan may not be directly rolled over into a Roth IRA. These amounts must be rolled to a traditional IRA, and then later rolled from the traditional IRA to the Roth IRA.

After-tax contributions of employees may be rolled over from a tax-qualified retirement plan into another tax-qualified retirement plan, if the plan to which the rollover is made is a defined contribution plan, the rollover is accomplished through a direct rollover, and the plan to which the rollover is made provides for separate accounting for such contributions.

If an individual inherits an IRA from the individual's deceased spouse, the IRA may be treated as the IRA of the surviving spouse. However, in cases of inheriting an IRA from someone other than the individual's deceased spouse, the IRA is not treated as the IRA of the beneficiary, so the beneficiary may not make contributions to the IRA and is not allowed to roll over any amounts from the inherited IRA.

4.5.2 Expanded rollover rules enacted

Under a provision of the Pension Protection Act of 2006, distributions from tax-qualified retirement plans, 403(b) annuities, and the 457 plans are able to be rolled directly into a Roth IRA, subject to the same limitations that apply to rollovers from a traditional IRA into a Roth IRA. This provision is effective for distributions made after December 31, 2007.

Observation

Rollovers from retirement plans to Roth IRAs will trigger taxable income to the taxpayer, but there will be no 10 percent premature distribution penalty. Additionally, taxpayers with AGI of $100,000 or more are not allowed to roll over amounts from a tax-qualified retirement plan directly into a Roth IRA. However, as described in Section 4.1, this AGI limitation is removed starting in 2010.

Additionally, after-tax contributions are allowed to be rolled from the qualified retirement plan to another qualified retirement plan, whether a defined contribution or a defined benefit plan. Such rollovers can also occur to a tax-sheltered annuity, although the rollover must be a direct rollover and the plan to which the rollover is made must account separately for any after-tax contributions. This provision is effective for taxable years beginning after December 31, 2006.

Finally, benefits of a beneficiary other than a surviving spouse may be directly transferred to an IRA, with the IRA treated as an inherited IRA of a non-spouse beneficiary. Any distributions from the inherited

IRA are subject to the normal distribution rules that apply to beneficiaries and that apply to amounts payable to a beneficiary under a qualified retirement plan, 403(b) annuity, or 457 plan. Accordingly, the rollover amount is subject to the same minimum distribution rules as would occur with an inherited IRA from someone other than a spouse. This provision is effective for distributions after December 31, 2006.

4.6 Exceptions to 10 Percent Premature Distribution Penalty

The Pension Protection Act of 2006 added an additional exception to the 10 percent premature distribution tax, providing the exception for a qualified reservist distribution. A qualified reservist distribution is a distribution:

- Made from an IRA or attributed to elective deferrals under a 401(k) plan, 403(b) annuity, or similar arrangement,
- Made to an individual who by reason of being a member of a military reserve unit was ordered and called to active duty for a period in excess of 179 days or for an indefinite period, and
- Made during the period beginning on the date of the order or call to active duty and ending at the close of the active duty period.

A recontribution privilege is also available for a taxpayer who received a qualified reservist distribution, allowing a recontribution during the two-year period beginning on the day after the end of the active duty period. The changes are effective for distributions after September 11, 2001, for individuals ordered or called to active duty after September 11, 2001, and before December 31, 2007.

An additional exception to the 10 percent premature distribution penalty was added by the Pension Protection Act of 2006 for distributions from a governmental defined benefit pension plan to a qualified public safety employee who separates from service after age 50. This provision is effective for distributions made after August 17, 2006.

4.7 Miscellaneous Pension Provisions in the Pension Protection Act of 2006

The Pension Protection Act of 2006 directs the IRS to develop forms that allow all or a portion of a taxpayer's refund to be directly deposited into an IRA of the taxpayer, or the spouse of the taxpayer in the case of a joint return.

Observation

The IRS had previously announced the development of Form 8888, which will allow taxpayers who use direct deposit to divide a refund among two or three financial accounts, such as checking, savings, and retirement accounts (IR-2006-85).

401(k) plans with an automatic enrollment feature are treated as meeting the ADP test with respect to elective deferrals and the ACP test with respect to matching contributions. This provision is effective for taxable years beginning after December 31, 2007.

Observation

The automatic enrollment feature requires that employees must be 100 percent vested after two years, and that employees must be given regular annual written notice of the right to elect not to have elective contributions made.

Under another provision of the Pension Protection Act of 2006, the income limitations for IRA contributions are indexed for inflation beginning in 2007. These provisions apply to the income limits for deductible contributions to IRAs for active participants in an employer-sponsored plan, the income limits if the individual is not an active participant but the spouse of the individual is, and the income limits for Roth IRA contributions. Indexed amounts are rounded to the nearest multiple of $1,000.

Observation

This change does not affect the current provision dealing with the inflation indexing of the phase-out ranges.

The vesting schedule for matching contributions applies to all employer contributions to defined contribution plans. This vesting schedule requires 100 percent vesting after three years if cliff vesting is used, and 20 percent per year graded vesting over the period of two to six years if graded vesting is used. This new vesting schedule applies for contributions for plan years beginning after December 31, 2006.

4.8 Qualified Plan Limits

	2004	*2005*	*2006*
Maximum annual benefit under defined benefit plan	$165,000	$170,000	$175,000
Maximum contribution to defined contribution plan	$ 41,000	$ 42,000	$ 44,000

	2004	*2005*	*2006*
Maximum compensation generally taken into account under qualified retirement plan and SEPs	$205,000	$210,000	$220,000
Elective deferral limits for 401(k) plans, SEPs, etc.	$ 13,000	$ 14,000	$ 15,000
—Additional age 50 elective deferral	$ 3,000	$ 4,000	$ 5,000
Compensation requiring SEP coverage	$ 450	$ 450	$ 450
Earnings definition of a highly compensated employee	$ 90,000	$ 95,000	$100,000
Maximum deferral under SIMPLE plan	$ 9,000	$ 10,000	$ 10,000
—Additional age 50 deferral	$ 1,500	$ 2,000	$ 2,500

4.9 IRA Rollovers

4.9.1 Background

Taxpayers are allowed to roll over IRA distributions into another IRA, although this rollover must generally be completed within 60 days of the distribution.

The IRS has been granted the authority to waive the 60-day rollover rule in cases of hardship or what would represent unfair circumstances to a taxpayer.

4.9.2 IRA settlement proceeds allowed to be rolled over

The IRS has issued a private ruling allowing settlement proceeds received from investment companies and paid to a taxpayer for mismanagement of an IRA to be rolled over into a new IRA (PLR 200534026).

The taxpayer had brought action against the investment companies, claiming they had invested the IRA funds in high risk securities, despite the direction of the taxpayer. Eventually, the investment companies settled with the taxpayer and paid the taxpayer a monetary amount, a portion of which was represented by a check payable to the IRA, intended to offset the approximate amount the taxpayer lost from the alleged mismanagement.

The IRS allowed the settlement amount to be rolled over to the IRA, finding that the amount was intended to represent a replacement for the funds the taxpayer had lost in the original IRA.

5. FRINGE BENEFITS

5.1 Nonqualified Deferred Compensation Plans

5.1.1 Background

The use of deferred compensation arrangements to defer current taxation of income is widely used by many businesses. Congress believed that many nonqualified deferred compensation arrangements allowed improper deferral of income, often providing security of future payment and control by the employee over amounts deferred, but yet resulted in deferral of the recognition of the income.

5.1.2 Comprehensive rules for nonqualified deferred compensation arrangements enacted

The American Jobs Creation Act of 2004 added Section 409A to provide comprehensive rules regarding the inclusion in gross income of deferred compensation under nonqualified deferred compensation plans. If at any time a nonqualified deferred compensation plan fails to meet any one of three requirements, the compensation plus related earnings must be included in taxable income of the employee, with the tax increased by a 20 percent penalty (calculated as 20 percent of the compensation!), and increased by interest (at the IRS underpayment rate plus 1 percent) on the underpayments that would have occurred had the deferred compensation been includable in income for the year in which first deferred. The three requirements that must continuously be met to avoid early taxation plus a penalty and interest are:

1. The distribution rule.
2. The election rule.
3. The acceleration of benefits rule (under which the plan may not permit the acceleration of the time or schedule of any payment, except as provided in regulations).

The Distribution Rule. The plan of deferred compensation must not permit distributions earlier than separation from service, the date the participant becomes disabled, death, a specified time or pursuant to a fixed schedule specified under the plan at the date of the deferral of the compensation, a change in the ownership or effective control of the employer, or the occurrence of an unforeseeable emergency.

Observation

These distribution rules, combined with the prohibition against any acceleration of benefits, will prevent an employee from electively accelerating the receipt of deferred compensation. It will also eliminate

"haircut" provisions that allowed participants to receive early distributions at their election, subject to a minimal forfeiture or "haircut."

Election Rule. The initial election to defer compensation must be made not later than the close of the preceding tax year. However, in the case of the first year in which the participant becomes eligible to participate in a deferred compensation plan, the election may be made with respect to services to be performed subsequent to the election within 30 days after attaining eligibility to participate in the plan. Also, performance based compensation based on performance over a period of at least 12 months may be deferred via election no later than six months before the end of the period.

A change in the time and form of distribution may be made under a subsequent election, but only if the election may not take effect until at least 12 months after the date on which made. Also, unless the election relates to a distribution on account of death, disability, or unforeseeable emergency, any deferral must be at least five years from the date on which such payment would otherwise have been made. If the deferred compensation is to be paid at a specific time or pursuant to a fixed schedule, any subsequent deferral election may not be made less than 12 months prior to the date of the first scheduled payment.

5.1.3 Definition of a nonqualified deferred compensation plan

A nonqualified deferred compensation plan is any plan that provides for the deferral of compensation other than a qualified employer plan and any bona fide vacation lease, sick leave, compensatory time, disability pay, or death benefit plan. Qualified employer plans excluded from these deferred compensation rules include Section 401 qualified pension and profit sharing plans, tax-deferred annuities, SEPs and SIMPLE plans.

Observation

The nonqualified deferred compensation rules do not apply to bonuses and other annual compensation amounts that are paid within 2½ months after the close of the tax year in which the services were performed. Also, the application of these rules is not limited to employees, but extends to deferral agreements with directors and other independent contractors.

Employer Reporting Requirements. If a nonqualified deferred compensation arrangement fails the criteria of Section 409A, the employer must include deferred compensation in income, reporting the amount on either Form W-2 or Form 1099. In addition, the total amount of deferrals for the year under a nonqualified deferred compensation plan must

be reported on the Form W-2, even though not includable in income. Per IRS Notice 2005-1 (Q&A 27), a minimal amount of annual deferral of $600 or less does not require memorandum reporting.

5.1.4 Effective date and transition rules

The new nonqualified deferred compensation rules of Section 409A apply to any compensation deferred after December 31, 2004. Amounts earned and vested before January 1, 2005, are grandfathered. However, amounts deferred before January 1, 2005, are subject to the new rules if a material modification is made to the nonqualified deferred compensation plan after October 3, 2004. The addition or acceleration of any benefit or feature is a material modification, but the reduction of a benefit, right, or feature is not considered a material modification.

Within 60 days of enactment of the legislation, the IRS was directed to provide guidance regarding amendment of plans to conform to the new rules, and a limited period during which existing plans may be amended to either terminate participation in the plan or to conform to the requirements of Section 409A with regard to amounts deferred after December 31, 2004. This Congressional mandate to provide guidance was subsequently satisfied with IRS Notice 2005-1 (IRS Notice 2005-1, IRB No. 2005-2).

IRS Notice 2005-1 allowed a remedial period *through December 31, 2005,* under which existing or new nonqualified deferred compensation plans could be amended in order to comply with the provisions of Section 409A. The plan must be operated in good faith compliance with the provisions of the statute and IRS Notice 2005-1 during calendar year 2005. This remedial period was extended in late September, 2005, *through December 31, 2006,* by IRS regulations.

Observation

The addition of Section 409A will require the review of virtually every nonqualified deferred compensation plan. While many plans will need to remove provisions that are not in compliance with Section 409A, other plans will benefit by conforming. An example would be the new ability to accelerate benefits in the event of an unforeseen emergency, which has not been contained in many existing deferred compensation agreements.

5.1.5 GOZA technical correction

Per a technical correction in the Gulf Opportunity Zone Act of 2005, the additional 20 percent penalty and interest are not treated as payments of regular tax for purposes of determining whether the AMT applies [§26(b) and §409A(a)(4)(C)(ii)].

5.2 Health Savings Accounts (HSAs)

5.2.1 Background

As part of the Medicare Prescription Drug Act of 2003, Congress enacted a replacement for the Medical Savings Account, known as the Health Savings Account or HSA (§223, P.L. 108-173, 12/8/2003). HSAs became effective in 2004.

Observation
The HSA is significantly more taxpayer friendly than the MSA. The HSA has a lower deductible on the high deductible health insurance policy, allows a greater percentage of the deductible to be funded (that is, 100 percent rather than 65 percent or 75 percent), and allows individuals between ages 55 and 65 to make catch-up contributions to the HSA. Large employers, as well as small employers, can participate in an HSA, while MSAs only are available to smaller businesses. Finally, the HSA legislation is permanent, while MSAs were limited in number and duration.

5.2.2 Eligible individual

An eligible individual is one who is covered under a high deductible health insurance plan and, while covered under the high deductible plan, is not covered under any other non-high deductible health plan [§223(c)(1)]. However, an individual remains eligible for an HSA if he or she is covered under workers' compensation, insurance for a specified disease or illness, insurance paying a fixed amount per day, or insurance coverage for accidents, disability, dental care, vision, or long-term care.

An individual generally becomes ineligible for an HSA at age 65 when that individual enrolls in Medicare [§223(b)(7)]. The IRS has clarified that mere eligibility for Medicare does not prohibit HSA eligibility; actual Medicare Part A or Part B enrollment must occur to preclude HSA contributions (IRS Notice 2004-50, IRB No. 2004-33).

5.2.3 High deductible health plan

In the case of individual coverage, a high deductible health plan must have an annual deductible of at least $1,050, and the exposure to annual out-of-pocket expenses may not exceed $5,250. For family coverage, there must be an annual deductible of at least $2,100 in total (per family, not per person), and annual out-of-pocket expenses may not exceed $10,500 (2006 amounts) [§223(c)(2)(A)].

5.2.4 The Health Savings Account

The Health Savings Account (HSA) is a trust established exclusively for the purpose of paying the qualified medical expenses of the account beneficiary. It must be governed by a written instrument, all investments must be in cash, and the trustee must be a bank, insurance company, or other institution of the type that can sponsor an IRA. No part of the trust assets may be invested in life insurance. The trust may accept rollover contributions from an Archer MSA.

5.2.5 Maximum HSA contribution

The maximum for an individual coverage HSA that can be contributed annually is the smaller of the annual deductible or $2,700 (2006 amount). With respect to an HSA involving family coverage, the annual contribution is the smaller of the annual deductible or $5,450 (2006 amount) [§223(b)(2)]. These annual HSA funding limits are converted to monthly amounts, because eligibility for funding hinges on participation in a high deductible health plan. For each month that an individual is an eligible participant in a high deductible health plan, they are entitled to contribute 1/12th of the HSA funding limit.

Age 55 Catch-up Contributions. If an individual has attained age 55 at the end of the tax year, the annual HSA contribution limit is increased by $700 for 2006. This catch-up limitation increases $100 annually, until reaching a total of $1,000 for 2009 and years following.

HSA contributions made by an individual are allowed as a pre-AGI deduction.

5.2.6 Employer contributions

Employers, as well as individuals, are permitted to contribute to HSAs, to the extent the employee is an eligible individual. If an employer makes a contribution to employee HSA accounts, comparable contributions must be made for the year for all comparably participating employees. Employer contributions are a tax-free benefit in the same manner as health insurance, and are also not subject to payroll taxes or income tax withholding.

5.2.7 Withdrawals from the HSA

Funds within the HSA grow free of income tax. The account beneficiary determines when withdrawals occur. Withdrawals taken to pay or reimburse out-of-pocket medical expenses are tax-free, but withdrawals not used for medical costs are taxable and subject to a 10 percent penalty.

Even though a HSA participant may not continue to fund an HSA after age 65 (because of Medicare eligibility), the individual may continue to hold and accumulate HSA funds. An age 65 or older participant

can also withdraw HSA funds tax free for use to pay health insurance premiums or Medicare Part B premiums, as well as other medical costs.

Observation
The individual HSA participant determines whether to use his or her HSA account to reimburse any eligible medical costs. Accordingly, HSA participants have the unique flexibility of accumulating the HSA account balance for future post-retirement medical needs, if desired. While an HSA participant cannot contribute to an HSA account after enrolling in Medicare, the HSA account can be maintained and used for reimbursement of medical costs during retirement years by the participant or spouse.

Upon death, a surviving spouse can succeed to an HSA account of the deceased spouse, assuming the surviving spouse was named as the successor beneficiary. To the extent a surviving spouse is not the successor beneficiary, the fair market value of the HSA must be includable in the income of the person or persons who inherit the account, reduced by any medical expenses of the decedent paid from the account within one year after death [§223(f)(8)].

5.2.8 Further IRS guidance

Following the enactment of Section 223, the IRS issued significant guidance to assist employers and individual taxpayers in establishing HSAs:

General Guidance. Shortly after enactment of Section 223, the IRS issued Notice 2004-2, containing 38 questions and answers covering most aspects of HSAs (IRS Notice 2004-2, IRB No. 2004-2).

A more exhaustive summary of HSAs was provided later in 2004. In Notice 2004-50, the IRS issued an 88 question-and-answer release that covered additional information on eligibility, high deductible health plans, preventive care, contributions, distributions, comparability of employer funding, rollovers, and other matters (IRS Notice 2004-50, IRB No. 2004-33).

The IRS has issued a publication that provides a summary of HSA rules in a form that is suitable for business owners and clients. See IRS Pub. 969, *Health Savings Accounts and Other Tax-Favored Health Plans.* Also, at the U.S. Treasury Web site, the IRS has posted guidance in the form of "Frequently Asked Questions" regarding the establishment, use and administration of HSAs. See www.treasury.gov under Health Savings Accounts HSA.

The IRS has issued a ruling clarifying that an individual with a high deductible health insurance plan may contribute to an HSA, even if that individual's spouse has nonqualifying family coverage, provided

that the spouse's nonqualifying coverage does not cover the individual. Further, an individual with an eligible high deductible health plan for any dependents not covered by a spouse's ineligible health plan may contribute to an HSA based on family coverage (Rev. Rul. 2005-25, IRB No. 2005-18).

Example. Ken, a self-employed individual, has a high deductible health insurance policy that only covers himself. Ken's spouse, Barb, has other ineligible health plan family coverage that covers Barb and their two children, but Ken is excluded from Barb's low deductible health plan coverage. Because Ken is not covered under Barb's health plan, he is an eligible individual for an HSA.

Example. Assume the same facts as in the preceding example, except that Ken enrolls in a high deductible health insurance plan that provides family coverage for himself and one child. Again, Barb has ineligible low deductible health plan coverage for herself, and one other child is included in Barb's plan, but Ken is excluded from coverage in her plan. Because the ineligible health plan coverage of Barb does not cover Ken, Ken's HSA eligibility is not affected.

5.2.9 Final regulations on comparability rules for employer contributions

Final regulations have now been issued by the IRS, providing guidance on the comparable contribution rules that an employer must follow when the employer makes contributions to an employee's HSA (Regs. §§54.4980G-1 through 54.4980G-5, T.D. 9277, 7/28/2006).

6. TAX CALCULATIONS AND TAX CREDITS

6.1 Alternative Minimum Tax

6.1.1 Background

A taxpayer who is liable for the regular tax may also be liable for the alternative minimum tax (AMT). Taxpayers may have to pay this tax if their taxable income for regular tax purposes, plus or minus certain adjustments and preferences, totals more than an applicable exemption amount.

Adjustments are different from tax preferences in that an adjustment either increases or decreases income subject to the AMT. However, tax preferences always increase income subject to the AMT. In computing alternative minimum taxable income, the following adjustments are used:

- Standard deduction
- Personal exemption
- Medical and dental expense
- Miscellaneous itemized deductions [as defined in Section 67(b)]
- Taxes
- Interest
- Depreciation of property placed in service after 1986
- Circulation and research and experimental costs paid or incurred after 1986
- Mine exploration and development costs paid or incurred after 1986
- Long-term contracts entered into after February 28, 1986
- Pollution control facilities placed in service after 1986
- Adjusted basis for gain or loss (where regular tax and AMT basis differs)
- Incentive stock options
- Tax shelter farm loss [§58(a)]
- Passive activity loss [§58(b)]
- Distributions from estates and trusts [§59(c)]
- Alternative tax net operating loss deduction

These adjustments require the taxpayer to recompute deductions and deferrals that tend to offset the reduction these items produce in the taxpayer's taxable income. The principal effect of this system is that it permits "netting." That is, these adjustments can *increase* or *decrease* alternative minimum taxable income. The reduction could occur in a year when, for example, the Alternative Depreciation System deduction exceeds the MACRS deduction (in later years of an asset's recovery period when the MACRS deduction is understated since it had been overstated in earlier years). Thus, the "netting process" recognizes that, in general, using tax preferences effects a deferral, rather than a complete reduction, in tax liability.

For 2005, the AMT exemption amounts were as follows:

Filing Status	*AMT Exemption Amount*
Joint return and Surviving Spouse	$58,000
Single and Head of Household	$40,250
Married filing separately	$29,000

6.1.2 AMT exemption amounts increased for 2006

The AMT exemption amounts for 2006 have been increased by the Tax Increase Prevention and Reconciliation Act as follows:

Filing Status	*AMT Exemption Amount*
Joint return and Surviving Spouse	$62,550
Single and Head of Household	$42,500
Married filing separately	$31,275

6.2 Preferential Rates for Capital Gains and Dividends Extended Through 2010

6.2.1 Background

The rates on long-term capital gains were reduced to 5 percent (0 percent in 2008) and 15 percent by the 2003 Tax Act, respectively, for sales and exchanges on or after May 6, 2003, and through December 31, 2008. The reduced rates apply for individuals, as well as estates and trusts. The lower rates apply for both the regular tax and AMT.

Similarly, dividend income received in taxable years beginning after December 31, 2002 and before 2009 by an individual shareholder, along with estates and trusts, from a domestic or qualified foreign corporation is taxed at the rates applicable to long-term capital gains, with such dividend income received by a taxpayer in the upper ordinary tax brackets taxed at 15 percent and dividend income received by an individual in the lower tiered 10 percent and 15 percent ordinary tax brackets taxed at 5 percent (0 percent for tax years beginning in 2008). Again, these preferential rates for dividend income apply for both regular tax and AMT.

6.2.2 Lower rates extended through 2010

The Tax Increase Prevention and Reconciliation Act extended the lower preferential rates on long-term capital gains and qualified dividends that apply for both regular tax and AMT through the end of 2010. Accordingly, the 0 percent rate originally scheduled to apply only in the year 2008 will now apply for the years 2008, 2009, and 2010.

Observation

As under prior law, taxpayers are able to elect to treat net capital gains from investment property and/or qualifying dividends as investment income, subject to ordinary tax rates, for purposes of deducting investment interest expense through 2010.

6.3 Kiddie Tax

6.3.1 Background

The so-called "kiddie tax" rules have applied to children under age 14 who have unearned income of more than an inflation-adjusted amount. This amount was $1,600 in 2005. The "kiddie tax" presents a challenge to many family income splitting techniques that took advantage of the lower rates of the children of a taxpayer. In effect, the kiddie tax rules taxed the family unit as a whole. Unearned income generally includes all income except wages, salaries, and self-employed earnings.

6.3.2 Change in age of kiddie tax

The Tax Increase Prevention and Reconciliation Act has increased the age at which the kiddie tax rules apply to under age 18 for 2006 and future years. It had been under age 14 prior to 2006. The inflation-adjusted amount is $1,700 in 2006. However, the kiddie tax does not apply to a child who is married and files a joint return for the taxable year.

Observation
This legislative change may affect the investment strategy of college funding. If the funds are retained in an interest-bearing account, the earnings are taxed at the parents' rate. Alternatively, if the funds are moved into mutual funds or growth stock, more risk may be introduced than the taxpayers originally bargained for. Because of this, Section 529 plans and Coverdell Savings Accounts may become more attractive as vehicles for higher education funding.

6.4 Long-distance Telephone Excise Tax

6.4.1 Background

Section 4251 applies a 3 percent excise tax on long-distance telephone communications. Despite its defeat in several courts, the IRS continued to maintain that the excise tax applied where the toll charge varied with either distance or elapsed time of the call, rather than when it varied with *both* distance and elapsed time.

Observation
The IRS had previously been defeated on this issue in numerous appellate court settings, including the Second, Third, Sixth, Eleventh, and Federal Circuits.

6.4.2 IRS concedes excise tax issue

Following its long string of defeats in the courts, the IRS has finally conceded the fact that the excise tax does not apply to long-distance calls where the charges are computed on an elapsed time basis, regardless of the distance of the call (IRS Notice 2006-50, IRB No. 2006-25).

Observation
The excise tax has been paid by both businesses and individuals in the past, so all these parties will be entitled to a refund opportunity on the excise tax previously paid. The IRS has provided a safe harbor opportunity for individuals to obtain a credit or refund of tax previously paid.

Taxpayers are able to obtain a credit or refund of previous excise tax paid on their 2006 income tax returns. The IRS has indicated it will issue a revised Form 1040 and Form 1120, along with instructions, to allow the refund amount to be claimed. Taxpayers not otherwise required to file a tax return will need to do so to obtain a refund of the tax amount.

Observation
Businesses who previously deducted the tax as a business expense will be required to include any refund amount in future income. However, under the tax-benefit rule of Section 111, refund amounts will only need to be included in future income to the extent the deductibility of the excise tax has provided tax benefit in the past.

The IRS has announced safe harbor refund amounts that individual taxpayers, including Schedule C filers, can use (IRS News Release 2006-137, 8/31/2006):

Number of Exemptions	*Telephone Excise Tax Refund*
One	$30
Two	$40
Three	$50
Four or More	$60

6.5 Section 475(f) Election

6.5.1 Background

Individual taxpayers who buy and sell securities normally qualify as either an investor or trader. Generally, the tax rules are more favorable

for traders than for investors. Traders engage in transactions so regular and continuous as to rise to the level of a trade or business. This allows a trader to deduct business expenses on Schedule C, even though the security gains and losses are given capital gain treatment and reported on Schedule D.

Both investors and traders are entitled to capital gain treatment on the sale of qualifying assets, but traders are allowed to make an election under Section 475(f) which allows them to mark their stock holdings to market at the end of the tax year. This election is not available to investors.

A Section 475(f) election allows all security gains and losses to be treated as ordinary income or loss, with treatment of all security holdings at the end of the year as if a deemed sale occurred, forcing recognition of any unrealized gains or losses. While ordinary, rather than capital, treatment applies to the security transactions, the benefit of making the Section 475(f) election is that neither the $3,000 capital loss limitation nor the wash sale rules apply to a taxpayer who has made such an election.

The exclusive procedure for traders to make a Section 475(f) election is provided in Rev. Proc. 99-17 (1999-1 CB 503). Under Rev. Proc. 99-17, taxpayers must file a statement no later than the due date, not excluding extensions, of the original federal income tax return for the taxable year *preceding* the election year (for example, April 15, 2006, for the 2006 taxable year).

6.5.2 Late Section 475(f) election allowed

The Tax Court has allowed a taxpayer to make a late-filed Section 475(f) election, finding that the taxpayer conducted no trading activity between the date the election should have been filed and the date it was actually filed, while also finding the taxpayer had been given no professional advice to make the election (*Vines v. Comm.*, 126 TC No. 15, 5/11/2006).

The taxpayer suffered an approximate $25 million stock loss three days before the deadline for filing a Section 475(f) election. Neither the tax adviser which the taxpayer used for an extended period nor a second accountant with whom he consulted were aware of the Section 475(f) election and thus made no recommendation to the taxpayer to make the election. Later, upon learning of the availability of the election, the taxpayer hired a law firm to prepare the election and file it on his behalf.

While the IRS denied the late-filed election, the court looked to the unusual and compelling facts in the case in allowing the applicability of the late-filed election.

Observation

The importance of recognizing the availability of the election and timely making the election cannot be overstated. While this taxpayer prevailed with a late-filed election, the taxpayer encountered considerable expense in achieving the approval of the election.

6.6 Savers Credit Becomes Permanent

6.6.1 Background

A nonrefundable tax credit is provided for eligible taxpayers for contributions to qualified retirement savings accounts, with a maximum annual contribution eligible for the credit of $2,000 per taxpayer. The credit amount depends on the AGI of the taxpayer, with joint returns of $50,000 or less of AGI, head of household returns with $37,500 or less of AGI, and single returns of $25,000 or less of AGI eligible for the credit. The credit applies in addition to any deduction or exclusion otherwise applicable with respect to the contribution and, additionally, the credit offsets AMT as well as the regular tax. The credit is available to individuals age 18 or older, other than individuals who are full-time students for five months of the year and are claimed as a dependent on the return of another taxpayer.

IRS Form 8880, *Credit for Qualified Retirement Savings Contribution*, is used to claim the credit.

6.6.2 Indexing added and credit made permanent

The Pension Protection Act of 2006 has made the Savers credit permanent. Additionally, the Act also indexes the AGI limits applicable to the Savers credit, beginning 2007, with the indexed amounts rounded to the nearest multiple of $500.

6.7 Child and Dependent Care Credit

6.7.1 General rules

General rules applicable to the child and dependent care credit follow.

6.7.2 Qualifying individual

1. Taxpayer's dependent under age 13 for whom taxpayer is entitled to a dependency exemption.
2. Taxpayer's dependent who is physically or mentally disabled (for example, parent).

3. Taxpayer's disabled spouse who has the same principal place of abode for over half the year [§21(b)(1)].

6.7.3 Maximum credit allowed

1. A maximum 35 percent credit is allowed, reduced by one percentage point for each $2,000 of adjusted gross income exceeding $15,000.
2. A minimum 20 percent credit applies.
3. The maximum amount of employment-related expenses taken into account is $3,000 for one dependent and $6,000 for two or more [§21(c)].

6.7.4 Requirement that taxpayer maintain a home eliminated

Effective for 2005, Congress has eliminated the requirement that a taxpayer maintain a home in order to claim the child and dependent care credit. Effective in 2005, a taxpayer may claim the child care credit with respect to a child living more than half of the year with the taxpayer, even if the taxpayer does not provide more than half the cost of maintaining the household [§21(e)(1), as amended].

6.7.5 Proposed regulations on child and dependent care credit

The IRS has issued new proposed regulations relating to the child and dependent care credit (Prop. Regs. §§1.21-1 through 1.21-4, REG-139059-02, 5/24/2006). The regulations update previous regulations in the area, encompassing changes enacted by the Working Families Tax Relief Act of 2004, including clarification that qualifying individuals must have the same principal place of abode as the taxpayer claiming the credit for more than one-half of the tax year.

6.8 Adoption Credit

6.8.1 Background

Prior to 2002, Section 23 allowed a taxpayer to claim a credit of up to $5,000 for qualifying adoption expenses, and up to $6,000 per adoption of a domestic child with special needs. Beginning in 2002, the maximum adoption credit was increased to $10,000 per adoption of an eligible child. The credit is available until modified AGI reaches $150,000, with the credit then phased out proportionately as modified AGI moves from $150,000 to $190,000, with the same phaseout range applied to all categories of filers (single, joint, etc.). Both the adoption credit amount and the AGI phaseout amounts are adjusted annually for inflation.

6.8.2 Inflation-adjusted amounts for 2006

The dollar limit on the adoption credit for 2006 was indexed to $10,960 (Rev. Proc. 2005-70, IRB No. 2005-47). Similarly, the $40,000 AGI phase-out range for the credit was increased for 2006 from $164,410 to $204,410.

Observation
Under Section 26(a)(1), the adoption credit is permanently allowed to offset both regular tax and the alternative minimum tax.

6.9 Hope and Lifetime Learning Credits

6.9.1 Background

The Hope credit is available for a student who has not completed the first two years of post-secondary education as of the beginning of the tax year. It is calculated as 100 percent of the first $1,000 of qualified tuition and 50 percent of the next $1,000 of qualified tuition, for a maximum annual credit of $1,500 per student. For each eligible student, the Hope credit may be claimed for no more than two taxable years. The $1,000 amounts are indexed for inflation, rounded to $100 increments.

The Lifetime Learning credit is calculated as 20 percent of up to $10,000 of qualified tuition, for a maximum nonrefundable credit of $2,000. This limit applies per taxpayer, regardless of the number of students. Both degree and non-degree courses at a higher education institution are eligible, including those taken to acquire and improve job skills. There is no requirement of enrollment in a degree program and enrollment for at least half of the normal full-time workload, as occurs with the Hope credit.

6.9.2 Inflation-adjusted amounts for 2006

The inflation adjustment for the Hope credit for 2006 is calculated at 100 percent of the first $1,100 of qualified tuition and 50 percent of the next $1,100 of qualified tuition, for a maximum Hope credit in 2006 of $1,650 (Rev. Proc. 2005-70, IRB No. 2005-47).

Higher income taxpayers lose the benefit of these educational tax credits at higher AGI levels. The AGI levels are adjusted annually for inflation. The inflation adjustments for the AGI phaseout range for the education tax credits for 2006 are as follows:

- Joint filers lose the educational tax credits as modified AGI increases from $90,000 to $110,000 (Rev. Proc. 2005-70, IRB No. 2005-47).
- For single filers, the phaseout range for 2006 is from $45,000 to $55,000 of modified AGI.

6.10 Alternative Motor Vehicle Credit

6.10.1 Alternative motor vehicle credit added by 2005 Energy Act

As part of the 2005 Energy Act, Congress added an alternative motor vehicle credit that applies to four types of new vehicles:

- Qualified fuel cell motor vehicle.
- Advanced lean burn technology motor vehicle.
- Qualified hybrid motor vehicle.
- Qualified alternative fuel motor vehicle (§30B).

The following points are applicable to all versions of this credit:

- The credit is treated as part of the general business credit system for business taxpayers, and is treated as a personal tax credit for individual taxpayers acquiring a vehicle in a nonbusiness or nondepreciable context. However, to the extent of any business use, the credit is not permitted to the extent the deduction is claimed under Section 179 for the vehicle, nor may any double benefit be claimed for both business usage and eligibility for the credit.
- The vehicle must be new rather than used.
- The credits are available for vehicles placed in service after 2005. The various credits expire for years ranging from 2010 to 2015, depending on the particular category of vehicle.
- In the case of a vehicle purchased (but not leased) by a governmental or tax-exempt entity, the person who sold such vehicle to the exempt entity is treated as the taxpayer that placed the vehicle in service, and is entitled to the credit.

6.10.2 Qualified fuel cell motor vehicle

A credit of $8,000 is allowed for any qualified fuel cell motor vehicle with a gross vehicle weight rating of not more than 8,500 pounds. This credit escalates to greater amounts for heavier vehicles. In addition, there is an enhancement to the credit ranging from $1,000 to $4,000, based on the increased fuel efficiency of the vehicle compared to 2002 city fuel economy standards. A fuel cell vehicle is one propelled by power from one or more cells that convert chemical energy directly into electricity by combining oxygen with hydrogen fuel that is stored onboard the vehicle [§30B(b)].

6.10.3 Advanced lean burn vehicle credit

This version of the Section 30B vehicle credit applies to a passenger auto or light truck with an internal combustion engine that is designed to operate primarily using more air than necessary for complete combustion of the fuel, incorporating direct injection, and achieving at least 125 percent of increased fuel efficiency compared to 2002 model year city fuel economy standards. The credit increases incrementally as the percentage of fuel economy increases, with the credit ranging from $400 to $2,400. In addition, there is a conservation credit that ranges from $250 to $1,000 based on the lifetime fuel savings that the vehicle is anticipated to realize [§30B(c)].

6.10.4 Hybrid vehicle credit

A hybrid vehicle credit is allowed for vehicles that draw propulsion from both an internal combustion engine and a rechargeable energy storage system or heat engine.

Observation
Previously, hybrid vehicles, categorized as "clean fuel vehicles," resulted in a $2,000 deduction. This deduction was repealed for hybrid vehicles placed in service after 2005, and replaced by the alternative vehicle credit.

The qualified hybrid vehicle receives a credit using the same sliding scale that applied to the advanced lean burn vehicles. Accordingly, this credit will range from $400 to $2,400, based on the fuel economy, and an initial conservation credit from $250 to $1,000 also would be available, based on the projected gallons of fuel saved over the useful life of the vehicle [§30B(d)].

6.10.5 Alternative fuel vehicle credit

This credit applies to vehicles that burn only natural gas, LP, hydrogen, or 85 percent methanol. The credit allowed is based on a percentage of the incremental cost of the energy efficient components of the vehicle. The credit is 50 percent of the incremental cost of the energy enhancement, plus 30 percent if the vehicle receives clean air certification and meets or exceeds specified clean air standards [§30B(e)].

A reduced credit for alternative fuel vehicles is provided for "mixed fuel vehicles." These are vehicles that burn both alternative fuels and conventional petroleum-based fuels.

6.10.6 Guidance issued by IRS on alternative motor vehicle credit

The IRS has released initial guidance on the alternative motor vehicle credit, providing clarification on the manner in which a manufacturer can properly certify a vehicle (IRS Notice 2006-9, IRB No. 2006-6).

6.11 Residential Energy Credits

6.11.1 Background

No credits previously existed for energy improvements to a taxpayer's principal residence or for energy efficient property expenditures made to residential property.

6.11.2 Residential energy credits added by 2005 Energy Act

Effective for property placed in service 2006 and 2007, Congress has added two residential energy credits:

- $500 lifetime credit for energy improvements to a taxpayer's principal residence (§25C).
- 30 percent credit for energy efficient property expenditures made to residential property (§25D).

6.11.3 $500 lifetime credit

The $500 lifetime credit has two components:

10 percent qualified energy efficient improvements. Taxpayers are allowed a credit for 10 percent of the amount paid or incurred for qualified energy improvements, defined as energy efficient building envelope components installed as new property on a dwelling unit located in the United States that is the taxpayer's principal residence. A building envelope component is any insulation material or system specifically designed to reduce heat loss or gain, exterior windows (including skylights), exterior doors, and any metal roof containing pigmented coatings primarily designed to reduce the heat gain [§25C(c)]. However, only $200 of the $500 lifetime credit amount can be attributable to window improvements.

Residential energy property expenditures. The second component of the $500 lifetime energy credit for a taxpayer is a dollar-for-dollar credit for three items, but each item is subject to a specific dollar cap on the credit:

1. Energy efficient building property (such as heat pumps, efficient central air conditioners, or water heaters), subject to a $300 cap,
2. Qualified natural gas, propane, or oil furnace or hot water boiler, subject to a $150 cap, or
3. An advanced main air circulating fan, subject to a $50 credit cap.

These expenditures must be installed in a dwelling unit which is the taxpayer's principal residence, and must be new items rather than used [§25C(d)].

6.11.4 30 percent credit for residential energy-efficient property

Individuals are allowed a credit in the amount of 30 percent of the following residential energy-efficient property expenditures:

- 30 percent of qualified photovoltaic property expenditures (using solar energy to generate electricity in a dwelling), subject to a credit cap of $2,000 per year,
- 30 percent of the qualified solar water heating property expenditures, subject to a $2,000 credit cap for any tax year, and
- 30 percent of the qualified fuel cell property expenditures, subject to a $500 credit cap for each half kilowatt of capacity of qualified fuel cell property [§25D(a) and (b)(1)].

Observation

The qualifying fuel cell property expenditure credit must involve a dwelling unit used as a principal residence by the taxpayer, while the other two credits are available for expenditures in a dwelling unit used as a residence (but not necessarily the principal residence) of the taxpayer. Any excess credit becomes a carryforward to future years [§25D(c)].

The 30 percent credit is effective for property placed in service after 2005 and before 2008 [§25D(g)].

6.11.5 IRS announces certification procedures for alternative motor vehicle credit

The IRS has announced certification procedures and has detailed general rules for eligible energy-efficient home improvements placed in service in 2006 and 2007 (IRS Notice 2006-26, IRB No. 2006-11).

6.12 Foreign Tax Credit

6.12.1 Background

U.S. citizens and residents are taxed on their worldwide income, but because the country in which the income is earned may also impose an income tax, foreign-source income may be subject to double taxation. To minimize the impact of such double taxation, the Code provides a foreign tax credit to the taxpayer. The foreign tax credit limitation is separately calculated for various categories of income, currently separated into nine limitation categories, which typically bear a high or low rate of foreign tax, designed to prevent a distortion of the foreign tax credit.

6.12.2 Nine limitation categories reduced to two categories in 2007

The American Jobs Creation Act of 2004 enacted a provision, reducing the number of categories or "baskets" for purposes of the foreign tax limitation from nine categories to two categories. The two categories consist of a passive category income and a general category income, effective for taxable years beginning after 2006 (Act Sec. 404, amending §904).

Observation

Passive category income includes passive income, and also includes dividends from DISCs, taxable income attributable to foreign trade income, and distributions from a Foreign Sales Corporation or a former Foreign Sales Corporation. General category income includes all income other than passive category income.

Transitional Rule

For taxes paid or accrued in taxable years beginning in 2005 and 2006, taxpayers may elect to treat foreign or U.S. possession taxes on non-U.S. income as imposed either on general limitation income or financial services income [§904(d)(2)(H)(i)].

6.13 AMT Treatment of Worthless Incentive Stock Option

6.13.1 Background

Noncorporate taxpayers are only allowed to recognize capital losses to the extent of capital gains plus $3,000 annually [§1211(b)]. However, noncorporate taxpayers are allowed to carry forward unrecognized capital losses to subsequent tax years, but these taxpayers are not allowed to carry back unrecognized capital losses to prior years [§1212(b)].

6.13.2 Capital loss limitations apply for both regular tax and AMT

The Tax Court, in two fully reviewed opinions, has ruled that the regular tax capital loss limitations also apply for purposes of calculating AMT (*Merlo v. Comm.*, 126 TC No. 10, 4/25/2006; *Montgomery, et ux v. Comm.*, 127 TC No. 3, 8/28/2006).

In one of the cases, incentive stock options (ISOs) had been exercised in the year 2000, triggering a gain of approximately $1 million. Because of a bankruptcy filing by the company, the shares became worthless in that following year, resulting in a capital loss for AMT purposes of approximately $1 million.

The taxpayer presented an argument that the regular tax capital loss limitation should not apply for AMT purposes, or that alternatively, the AMT capital loss could be carried back to offset the year 2000 AMTI. However, the court ruled otherwise, requiring the taxpayer to include the entire spread between the exercise price and the fair market value of the shares on the date the ISO was exercised in the year 2000 AMTI, while also holding that the capital loss limits that applied for regular tax applied for AMT.

In the *Montgomery* case, a similar fact pattern occurred, with the exercise of ISOs triggering a substantial AMT tax liability. When the value of the shares declined, a large capital loss was recognized by the taxpayer for AMT purposes. However, the court relied on its previous decision in *Merlo,* holding that the capital loss restrictions that apply for regular tax also apply for AMT and that no carryback of the capital loss for AMT purposes could occur.

Observation

These rulings resulted in terrible tax answers for the taxpayers involved, who were required to pay the AMT at the time the ISOs were exercised, but then found themselves with a large capital loss for AMT purposes when the company went bankrupt, with the AMT capital loss of only marginal value in the future.

6.14 Gift, Estate, and GST Rates

6.14.1 Background

Three integrated components comprise the federal transfer tax system:

- The federal estate tax (Chapter 11 of Code)
- The federal gift tax (Chapter 12 of the Code)
- The generation-skipping transfer (GST) tax (Chapter 13 of the Code)

6.14.2 2006 annual gift tax exclusion

The annual gift tax exclusion for 2006 has been increased to $12,000 (Rev. Proc 2005-70, IRB No. 2005-47).

6.14.3 Reduction in estate and GST taxes

Effective for transfers starting in 2006, the top rate applicable to estate and gift cumulative transfers has decreased from 47 percent (2005 rate) to 46 percent. Similarly, the GST flat rate has decreased from 47 percent to 46 percent for 2006.

Observation
These rates are scheduled to decrease to 45 percent in 2007, where they will remain until the estate tax and GST tax are repealed for one year in 2010.

6.14.4 Estate exemption amount increased

The estate exemption amount increased to $2 million for 2006, which is equivalent to a credit amount of $780,800. The GST exemption amount similarly increased to coincide with the estate tax exemption amount and will continue to coincide with that amount through 2009, until the scheduled repeal in 2010. However, the gift tax exemption amount remains at $1 million through 2010.

Observation
With the estate exemption amount and the GST exemption amount increasing to $2 million in 2006, the estate tax and GST tax are imposed at a flat rate of 46 percent in 2006 and will decrease to 45 percent in 2007 and thereafter, until the scheduled repeal in the year 2010.

6.14.5 Repeal of state death tax credit

Starting in 2005, the state death tax credit was repealed for federal estate tax purposes, with a deduction now allowed to the estate for any state death tax actually paid.

Observation
The IRS has revised Form 706, where line 3(b) is used to claim the deduction for any estate, inheritance, legacy, or succession taxes paid to any state or the District of Columbia, effective for deaths after 2004.

7. FILING AND COMPLIANCE MATTERS

7.1 Estimated Tax Payments

7.1.1 Background

Generally, taxpayers must make estimated tax payments if they determine their total tax liability for the year, reduced by withholding and estimated tax payments, will be $1,000 or more and they estimate the total amount of tax withholding from their income will not exceed the lesser of:

- 90 percent of the tax to be shown on this year's return, or
- 100 percent of the tax shown on last year's return [§6654(d)(1)(B)].

Note: Individual taxpayers can generally avoid penalties for failure to pay estimated tax by making payments during the year exceeding one of the above amounts, or by making payments on a current basis under an annualized income installment method.

In determining estimated tax liability, the alternative minimum tax must be taken into account.

7.1.2 Higher income taxpayers

For 2006, taxpayers with an adjusted gross income of more than $150,000 in 2005 ($75,000 for married persons filing separately) must use 110 percent, rather than 100 percent of their prior year's tax [§6654(d)(1)(C)]. This rule does not apply if at least two-thirds of the gross income for the current and prior years is from farming or fishing.

> *Example.* Fran's adjusted gross income for 2005 was $180,000 and the tax liability for that year was $50,000. Fran can avoid an underpayment penalty in 2006 if the total amount withheld and her estimated tax payments exceed $55,000 (110 percent of $50,000), because her last year's AGI was more than $150,000.

Farmers or Fishermen. If at least two-thirds of the taxpayer's gross income for the current and prior years is from farming and fishing, no estimate payments are required if the taxpayer files a return and pays all tax due by March 1 of the following year. Alternatively, a taxpayer can pay in estimates of at least 66 2/3 percent of the tax due by January 15 of the following year, with the remainder of the tax due paid by April 15 without penalty [§6654(i)].

Other Exceptions. The IRS has the authority to waive the underpayment of estimated tax in the event of a casualty, disaster or other unusual circumstance [§6654(e)(3)(A)]. Also, if a taxpayer retires in

a year after attaining age 62 or becomes disabled, the IRS has the authority to waive the penalty for reasonable cause [§6654(e)(3)(B)].

7.2 Direct Deposits of Tax Refunds

The IRS has announced that it is currently developing new Form 8888, which will allow taxpayers who use direct deposit of refunds to divide the refund among two or three financial accounts, such as a checking account, savings account, or retirement account.

Observation
Taxpayers who will deposit their refund into a single account may still use the appropriate line on page 2 of Form 1040.

7.3 Phase-out of Personal Exemptions and Itemized Deductions

7.3.1 Phase-out of personal exemptions

2001 tax legislation (P.L. 107-16) provides for a gradual elimination of the phase-out of personal exemptions. Beginning in 2006, the Act reduces the phase-out to two-thirds of what it otherwise would be. In 2008, the phase-out is reduced to one-third of its normally calculated amount, and in 2010 the personal exemption phase-out is repealed [§151(d)(3)(E) and (F), effective for tax years beginning after 2005].

7.3.2 Phase-out of itemized deductions

The 2001 Tax Act has scheduled the repeal of the phase-out of itemized deductions, beginning in 2006. In that year, one-third of the phase-out is eliminated. In 2008, two thirds of the phase-out is eliminated, and in 2010 this offset to itemized deductions is repealed [§68(f)].

7.4 Timely Mailing of Tax Returns

7.4.1 Background

The issue of "timely mailing of documents and payments treated as timely filed and paid" has been subject to considerable controversy. A long series of court cases has resulted in inconsistent decisions on the matter.

There have been numerous court decisions on this issue, but the issue has been rendered somewhat moot by a proposed regulation

issued by the IRS on September 21, 2004. However, for one of the most recent cases regarding the issue of timely mailing of tax returns, see *Sorrentino v. U.S.* (CA-10, 9/14/2004, rev'g. DC Co., 1/8/2002), in which the Tenth Circuit reversed a federal District Court decision and sided with the IRS.

7.4.2 IRS regulations

Reg. Section 301.7502-1 addresses the issue of timely mailing of documents and payments. The regulation goes into great detail regarding mailing requirements, along with the requirements of a U.S. Postal Service postmark. Reg. Section 301.7502-1(c)(1)(iii)(A) states the following:

> "If the postmark on the envelope is made by the U. S. Postal Service, the postmark must bear a date on or before the last date, or the last day of the period, prescribed for filing the document or making the payment. If the postmark does not bear a date on or before the last date, or the last day of the period, prescribed for filing the document or making the payment, the document or payment is considered not to be timely filed or paid, regardless of when the document or payment is deposited in the mail. Accordingly, the sender who relies upon the applicability of Section 7502 [dealing with the topic of "timely mailing treated as timely filing and paying"] assumes the risk that the postmark will bear a date on or before the last date, or the last day of the period, prescribed for filing the document or making the payment. See, however, paragraph (c)(2) of this section with respect to the use of registered mail or certified mail to avoid this risk."

Reg. Section 301.7502-1(c)(2) states the following regarding registered or certified mail:

> "If the document or payment is sent by U.S. registered mail, the date of registration of the document or payment is treated as the postmark date. If the document or payment is sent by U.S. certified mail and the sender's receipt is postmarked by the postal employee to whom the document or payment is presented, the date of the U.S. postmark on the receipt is treated as the postmark date of the document or payment. Accordingly, the risk that the document or payment will not be postmarked on the day that it is deposited may be eliminated by the use of registered or certified mail."

Reg. Section 301.7502-1(e)(1) deals with the topic of "delivery" and states the following:

> ". . . In the case of a document (but not a payment) sent by registered or certified mail, proof that the document was properly registered or that a

> postmarked certified mail sender's receipt was properly issued and that the envelope was properly addressed to the agency, officer, or office, constitutes prima facie evidence that the document was delivered to the agency, officer, or office."

On September 21, 2004, the IRS issued Prop. Reg. Section 301.7502-1 (REG-138176-02). This proposed regulation simply added two new sentences at the end of Reg. Section 301.7502-1(e)(1) which read as follows:

> "Other than direct proof of actual delivery, proof of proper use of registered or certified mail is the exclusive means to establish prima facie evidence of delivery of a document to the agency, officer, or office with which the document is required to be filed. No other evidence of a postmark or a mailing will be prima facie evidence of delivery or raise an assumption that the document was delivered."

In proposing Reg. Section 301.7502-1, the IRS indicated that the two sentences added to Reg. Section 301.7502-1(e)(1) will apply to all documents mailed after September 21, 2004, once the sentences are published as final regulations [Prop. Reg. §301.7502-1(g)(4)].

The IRS previously issued guidance in IRS Notice 2004-83 (IRB No. 2004-52) extending the "timely-mailed as timely-filed" rule to private delivery services (PDS) such as DHL, FedEx and UPS. However, under current rules, only if the IRS receives the item from the PDS is the receipt of the PDS allowed as proof of mailing. If the IRS has no record of receiving the item, the receipt is technically worthless. The IRS requested comments on treating a PDS equivalent to registered or certified mail in the preamble to Prop. Reg. Section 301.7502-1, but no additional guidance has been issued to date.

7.4.3 Exclusive means to prove timely mailing

Reg. Section 301.7502-1(c)(1)(iii)(A) regarding a U.S. Postal Service postmark is clear. A taxpayer cannot rely on such a postmark to prove timely mailing. Again, however, the use of registered or certified mail can avoid this postmark risk. Prop. Reg. Section 301.7502-1(e)(1) makes it clear that registered or certified mail is the *exclusive means* to establish prima facie evidence of delivery.

7.5 Criminal Tax Fraud: A Case Study

7.5.1 Background

Mr. Hoover was an Indiana grain and dairy farmer. For the three years under examination, he underreported his farm gross receipts by over

$100,000 per year. He did so largely by having the dairy cooperative and grain buyers issue checks in the names of two sons. However, Mr. Hoover had his sons endorse those checks and he received the proceeds. Neither he nor his sons reported the proceeds as taxable income (although apparently his sons believed that he was reporting the income from those sales).

7.5.2 The outcome

To illustrate how badly things can turn out when the government decides to pursue a taxpayer who has consistently and substantially understated income, here are the consequences that befell Mr. Hoover (*Hoover v. Comm.*, TC Memo 2006-82, 4/24/2006):

- He was indicted and convicted of willfully filing false returns for three years and given a federal prison sentence.
- He was ordered to make restitution by turning over $304,000 of face value U.S. savings bonds, to both cover his federal income tax liability and to reimburse the government for its accounting, legal, and expert testimony fees in pursuing the conviction.

Observation

The transfer of the U.S. savings bonds triggers the accrued interest income and Mr. Hoover presumably faced yet another tax liability!

- He was also convicted of making false statements on a student loan application (presumably based on false tax return information provided in the student loan application), and forced to make restitution on the student loan proceeds.
- The fraud penalty was imposed because of the consistent and substantial understatement of income, as well as the taxpayer's subsequent failure to cooperate with the IRS by failing to furnish records and by attempting to prevent the IRS from obtaining information from his tax return preparer.
- The filing of fraudulent returns allowed the IRS to pursue the taxpayer beyond the normal three-year statute of limitations.

7.5.3 Summary

Clearly, this particular taxpayer's conduct represented a pattern of unusually fraudulent behavior. But the severe sanctions serve to remind practitioners of how harsh the outcome can be when the IRS chooses to pursue this type of behavior to the fullest extent possible. When those difficult client questions arise, the story of the *Hoover* case can help the client understand that the consequences of underreported income are too costly to consider.

Practitioners also need to understand the exposure that exists if they are in any way complicit in a client's misconduct. That exposure is not merely the risk of an IRS preparer penalty, but more so an attack from the client. When the IRS goes beyond the assessment of tax and pursues a client for civil or criminal action, the first avenue their attorney often pursues is the "blame it on the accountant" defense. Unfailing integrity is in the practitioner's best interest as well!

7.6 Private Collection Agencies to Collect Unpaid Taxes

7.6.1 Background

Congress enacted legislation in the American Jobs Creation Act of 2004 authorizing the IRS to enter into tax collection contracts with private collection agencies. Under this authority, the IRS is able to use the private collection agencies to locate and contact taxpayers specified by the IRS, and to request full payment from the taxpayer, including authorization to offer an installment agreement for payment over a period of up to five years. The private collection agencies are also authorized to obtain information specified by the IRS with respect to a taxpayer, but a number of privacy safeguards and other taxpayer protections apply.

7.6.2 IRS announces contracts with three private collection agencies

The IRS has now announced (IRS Ann. 2006-63) that they have signed contracts with three private collection agencies and that those agencies will begin efforts to assist in the collection of delinquent federal tax liabilities in September, 2006. The IRS guidance also summarizes the taxpayer safeguards that will restrict the private collection agency activity. The agencies will only be used to make payment arrangements with delinquent taxpayers and will be unable to take enforcement actions or have involvement with offers in compromise. The IRS will also notify a taxpayer with correspondence that includes a publication summarizing the private collection agency program when referring an unpaid tax amount to a private collection agency.

7.7 Offers-in-Compromise

7.7.1 Background

The IRS has the authority to compromise any civil or criminal case arising under the Code. Generally, taxpayers initiate this process through an offer-in-compromise, which is an offer to the IRS to settle an outstanding tax liability for less than the total amount due.

Currently, a $150 user fee is imposed on most offers-in-compromise, payable upon submission of the offer to the IRS. Taxpayers may justify their offers-in-compromise on the basis of doubt as to collectibility of the tax, doubt as to liability of the tax, or on the basis of effective tax administration. Occasionally, the IRS takes a lengthy period to evaluate and approve an offer, sometimes exceeding a period of 12 to 18 months. There are two general categories of offers-in-compromise:

- Lump-sum offers
- Period payment offers

7.7.2 Offer-in-compromise requires partial payment with submission

The Tax Increase Prevention and Reconciliation Act enacted a provision requiring taxpayers to make partial payments to the IRS while an offer-in-compromise is being considered. Taxpayers must make a down payment of 20 percent of the offer-in-compromise with the application of a lump-sum offer, defined as one including a single payment, as well as payments made in five or fewer installments. Taxpayers are required to comply with the taxpayer's own proposed payment schedule for periodic payment offers while the offer-in-compromise is being considered and accordingly are required to include the payment of the first proposed installment with the offer.

Taxpayers must still pay a user fee, with the user fee submitted with the appropriate partial payment and applied to the outstanding tax liability of the taxpayer. The offer is deemed automatically accepted if the IRS does not reject the offer within two years from the date the offer-in-compromise was submitted. The new rules are effective for offers-in-compromise submitted on and after July 16, 2006.

The IRS has now issued guidance on how the changes enacted by the Tax Increase Prevention and Reconciliation Act affect the manner in which the offer-in-compromise program operates (IRS Notice 2006-68, IRB No. 2006-31). An offer-in-compromise is submitted on Form 656, *Offer in Compromise.* The IRS has posted a new version of Form 656, revised to reflect the legislative change in the Tax Increase Prevention and Reconciliation Act, on its Web site.

7.8 Form 1099 Reporting of Tax-exempt Interest Income

7.8.1 Background

All taxpayers required to file a tax return must report the amount of tax-exempt interest income received or accrued during the taxable year.

The reporting of tax-exempt interest income is important for a number of reasons, despite the general exclusion of tax-exempt interest from income:

- The interest income from qualified private activity bonds issued after August 7, 1986 is a preference item for AMT calculation purposes.
- Tax-exempt interest income is relevant in determining eligibility for the earned income credit
- Tax-exempt interest income is relevant in determining the amount of Social Security benefits includable in gross income.

7.8.2 Tax-exempt interest paid subject to information reporting requirements

The Tax Increase Prevention and Reconciliation Act enacted a provision requiring interest paid on tax-exempt bonds to be subject to the same information reporting requirements as for interest paid on taxable obligations, effective for interest paid after December 31, 2005.

Observation

No guidance on which form is to be used to report the tax-exempt interest income exists. Either the present Form 1099-INT will be used, or a new information reporting form for tax-exempt interest income will be developed.

Federal Corporate Tax Notes

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1. HURRICANES KATRINA, RITA AND WILMA RELIEF: GULF OPPORTUNITY ZONE ACT OF 2005

1.1 Introduction

During fall 2005, Congress passed legislation to provide immediate relief to individuals and businesses affected by Hurricane Katrina. That legislation, signed by the President on September 23, 2005, was called the Katrina Emergency Tax Relief Act of 2005 (H.R. 3768).

In response to the devastation of Hurricane Katrina, along with Hurricanes Rita and Wilma, Congress passed the Gulf Opportunity Zone Act (GOZA) of 2005, signed by the President into law on December 21, 2005. GOZA includes a significant number of federal tax incentives to encourage rebuilding and economic recovery in areas affected by Hurricanes Katrina, Rita, and Wilma. However, the legislation also enacts provisions that are totally unrelated to hurricanes.

1.2 Gulf Opportunity Zone Act of 2005 (P.L. 109-135)

Whereas GOZA establishes new tax breaks for individuals and business affected by the hurricanes, some of the GOZA relief measures are simply extensions of tax breaks initially included in the Katrina Emergency Tax Relief Act of 2005.

1.2.1 Geographical areas that qualify for the GOZA relief provisions

Six separate geographic areas are affected by the GOZA legislation.

1.2.1.1 Hurricane Katrina GO Zone

The Gulf Opportunity (GO) Zone is defined as that portion of the Hurricane Katrina Disaster Area determined by the President to warrant individual or individual and public assistance from the federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina. This is the same definition as was given to the Hurricane Katrina Core Disaster Area established by the Katrina Emergency Tax Relief Act.

The Katrina GO Zone covers Louisiana, Mississippi, and Alabama.

Louisiana: The parishes of Acadia, Ascension, Assumption, Calcasieu, Cameron, East Baton Rouge, East Feliciana, Iberia, Iberville, Jefferson, Jefferson Davis, Lafayette, Lafourche, Livingston, Orleans,

Plaquemines, Pointe Coupee, St. Bernard, St. Charles, St. Helena, St. James, St. John the Baptist, St. Martin, St. Mary, St. Tammany, Tangipahoa, Terrebonne, Vermillion, Washington, West Baton Rouge, and West Feliciana.

Mississippi: The counties of Adams, Amite, Attala, Choctaw, Claiborne, Clarke, Copiah, Covington, Forest, Franklin, George, Greene, Hancock, Harrison, Hinds, Holmes, Humphreys, Jackson, Jasper, Jefferson, Jefferson Davis, Jones, Kemper, Lamar, Lauderdale, Lawrence, Leake, Lincoln, Lowndes, Madison, Marion, Neshoba, Newton, Noxubee, Oktibbeha, Pearl River, Perry, Pike, Rankin, Scott, Simpson, Smith, Stone, Walthall, Warren, Wayne, Wilkinson, Winston and Yazoo.

Alabama: The counties of Baldwin, Choctaw, Clarke, Greene, Hale, Marengo, Mobile, Pickens, Sumter, Tuscaloosa, and Washington.

Florida: No counties eligible.

Observation

Many of the GOZA hurricane relief tax breaks are targeted to benefit the Katrina GO Zone, not the Rita or Wilma GO Zones.

1.2.1.2 Hurricane Katrina Disaster Area

The Hurricane Katrina Disaster Area means an area with respect to which a major disaster was declared by the President prior to September 14, 2005, under Section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina.

The Hurricane Katrina Disaster Area includes all of Louisiana, Mississippi, Alabama, and Florida.

1.2.1.3 Hurricane Rita GO Zone

The Rita GO Zone means that portion of the Hurricane Rita Disaster Area determined by the President to warrant individual or individual and public assistance from the federal government under Section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina.

The Rita GO Zone includes southern Louisiana and southeastern Texas.

Louisiana: The parishes of Acadia, Allen, Ascension, Beauregard, Calcasieu, Cameron, Evangeline, Iberia, Jefferson, Jefferson Davis, Lafayette, Lafourche, Livingston, Plaquemines, Sabine, St. Landry, St. Martin, St. Mary, St. Tammany, Terrebonne, Vermillion, Vernon and West Baton Rouge.

Texas: The counties of Angelina, Brazoria, Chambers, Fort Bend, Galveston, Hardin, Harris, Jasper, Jefferson, Liberty, Montgomery, Nacogdoches, Newton, Orange, Polk, Sabine, San Augustine, San Jacinto, Shelby, Trinity, Tyler, and Walker.

1.2.1.4 Hurricane Rita Disaster Area

The Hurricane Rita Disaster Area means an area with respect to which a major disaster was declared by the President prior to October 6, 2005, under Section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act, by reason of Hurricane Rita.

The Hurricane Rita Disaster Area includes all of Louisiana and Texas.

1.2.1.5 Hurricane Wilma GO Zone

The Wilma GO Zone means that portion of the Hurricane Wilma Disaster Area determined by the President to warrant individual or individual and public assistance from the federal government under Section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Wilma.

The Wilma GO Zone covers southern Florida.

Florida: The counties of Brevard, Broward, Collier, Glades, Hendry, Indian River, Lee, Martin, Miami-Dade, Monroe, Okeechobee, Palm Beach, and St. Lucie.

1.2.1.6 Hurricane Wilma Disaster Area

The Hurricane Wilma Disaster Area means an area with respect to which a major disaster was declared by the President prior to November 14, 2005, under Section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act, by reason of Hurricane Wilma.

The Hurricane Wilma Disaster Area covers all of Florida.

1.2.2 50 percent bonus depreciation for Katrina GO Zone property

Taxpayers are allowed an additional 50 percent first-year depreciation deduction calculated on the adjusted basis of qualified Katrina GO Zone property. To qualify, property must be placed in service on or before December 31, 2007 (December 31, 2008, in the case of nonresidential real property and residential rental property).

The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax (AMT) for the year the property is placed in service. The basis of the property and subsequent year depreciation allowances are adjusted to reflect the additional 50 percent first-year depreciation deduction. There is no adjustment to the allowable amount of depreciation for purposes of computing a taxpayer's AMT with respect to property to which the provision applies. That means there is no AMT depreciation adjustment for the entire depreciable basis of qualified property that is depreciated under the bonus rules. Taxpayers are allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.

Qualified property generally means tangible personal property with a recovery period of 20 years or less, software (other than software that is subject to 15-year amortization under Section 197), water utility property, qualified leasehold improvement property, certain nonresidential real property, and certain residential rental property. Original use of the property by a taxpayer must commence after August 27, 2005. However, both new and used property qualifies for the bonus depreciation; used property may constitute qualified property as long as it has not previously been used within the Katrina GO Zone.

The property must be acquired by purchase on or after August 28, 2005, and placed in service on or before December 31, 2007. For qualifying nonresidential real property and residential rental property, the property must be placed in service on or before December 31, 2008. Substantially all use of the property must be in the Katrina GO Zone and the property must be used in the active conduct of the taxpayer's business.

Other requirements exist in the statute, and any property, a portion of which is financed with the proceeds of a tax-exempt obligation under Section 103, is not eligible for the additional 50 percent first-year depreciation. Recapture rules apply if the property ceases to be qualified Katrina GO Zone property.

Example. Limco is an LLC taxed as a partnership for federal tax purposes. Limco places a new apartment building in service which is located in the Katrina GO Zone. Jerry, a member of Limco, manages and operates the apartment building. Because Jerry manages and operates the apartment building for Limco, Limco meaningfully participates in the management and operations of the activity and all of the use of the apartment building occurs within the Katrina GO Zone and in the active conduct of a business by Limco in that zone.

Accordingly, the unadjusted depreciable basis of the apartment building qualifies for the additional 50 percent bonus depreciation, assuming all other requirements are met. However, other Code limitations, such as the passive loss rules, may limit the deductible amount of the depreciation that can actually be claimed by members of Limco.

Example. Brenda operates a new restaurant in the Katrina GO Zone during 2006 and employs Leo to manage it. Brenda periodically meets with Leo to review operations relating to the restaurant and approves the budget of the restaurant prepared by Leo, although Leo completes all necessary management functions, including hiring chefs, purchasing the necessary food and restaurant supplies, and writing all checks for payroll and other bills.

Under this scenario, Brenda meaningfully participates in the management of the restaurant and the entire use of the restaurant within the Katrina GO Zone is considered in the active conduct of the business by

Brenda in the Katrina GO Zone. Accordingly, the unadjusted depreciable basis of the restaurant qualifies for the additional 50 percent bonus depreciation, assuming all other requirements are met. However, other limitations of the Code, such as the passive loss rules, apply and may limit the actual deductibility of the depreciation amount.

1.2.3 Increased Section 179 amount for Katrina GO Zone property

The $100,000 maximum Section 179 amount that a taxpayer may deduct is increased by the lesser of $100,000, or the cost of qualified Section 179 Katrina GO Zone property for the taxable year. The increased write-off applies with respect to qualified Section 179 Katrina GO Zone property acquired on or after August 28, 2005, and placed in service on or before December 31, 2007. This results in a maximum deductible about of $208,000 of qualified Section 179 Katrina GO Zone property for 2006 (the $108,000 regular Section 179 amount, increased by $100,000 under this provision). The $100,000 additional amount is not indexed for inflation.

The amount of property placed in service during a taxable year in which the Section 179 amount begins to phase out is increased by $600,000 for qualified Section 179 Katrina GO Zone property. The $208,000 potential write-off amount is reduced, but not below zero, by the amount by which the cost of qualified Section 179 Katrina GO Zone property placed in service during the year exceeds a dollar cap of up to $1 million. The dollar cap for 2006 is $1,030,000 ($430,000 regular Section 179 placed-in-service amount increased by the $600,000 in this provision). The $600,000 amount is not indexed for inflation.

Example. XYZ Corp's cost of Section 179 property that is qualified Katrina GO Zone property is $800,000 and XYZ acquires no other Section 179 property in that year. XYZ's deductible amount is increased by $100,000 to $208,000. Additionally, the normal $430,000 phase-out amount is increased by $600,000, so that the phase-out amount is $1,030,000.

XYZ's cost of Section 179 property is $800,000 total, so no reduction is made in the $208,000 amount that is eligible for write-off.

Example. Now assume that XYZ's cost of Section 179 property that is qualified Katrina GO Zone property is $200,000, and its cost of other Section 179 property is $450,000. The $430,000 normal phase-out amount is increased to $630,000 by the $200,000 cost of qualified Section 179 Katrina GO Zone property. XYZ had a total $650,000 cost of Section 179 property for the year, so XYZ's Section 179 deduction is reduced by the $20,000 difference between $650,000 and $630,000. Thus, XYZ may deduct $180,000 ($200,000 less $20,000) under Section 179 for the taxable year.

Caution

Both the special 50 percent bonus depreciation provision described in paragraph 1.2.2 and the Section 179 rules only apply to assets placed in service in the Katrina GO Zone, and not in the Rita GO Zone or the Wilma GO Zone.

1.2.4 Expensing for demolition and clean-up costs

Taxpayers are allowed to deduct 50 percent of any qualified Katrina GO Zone clean-up costs paid or incurred on or after August 28, 2005, and before January 1, 2008. The remaining 50 percent of the cost is required to be capitalized.

A qualified Katrina GO Zone clean-up cost is an amount paid or incurred for the removal of debris from, or the demolition of structures on, real property located in the Katrina GO Zone to the extent the amount otherwise would be capitalized. To qualify, property must be held for use in a business, for the production of income, or as inventory. This provision applies to costs paid or incurred on or after August 28, 2005, in taxable years ending on or after such date.

1.2.5 Expensing of environmental remediation cost

Taxpayers could elect to deduct, for eligible expenditures paid or incurred prior to January 1, 2006, certain environmental remediation expenditures that otherwise would represent a capital expenditure (Section 198). The deduction applied for both regular tax and AMT purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site.

This expensing provision has been extended for two years (i.e., through December 31, 2007) for qualified contaminated sites located in the Katrina GO Zone.

1.2.6 Five-year NOL carryback for losses in Katrina GO Zone

A special five-year carryback period, instead of the normal two-year period, is allowed for net operating losses attributable to certain Katrina GO Zone expenditures and casualty losses. Additionally, the rule that generally limits a taxpayer's NOL deduction to 90 percent of alternative minimum taxable income does not apply to any NOL subject to this special five-year carryback. Accordingly, such NOLs can be used to offset up to 100 percent of alternative minimum taxable income. Taxpayers are allowed to elect to forego the five-year carryback privilege. Other restrictions and privileges apply.

1.3 Tax Benefits Related to Hurricanes Rita and Wilma

1.3.1 Special rules for use of retirement funds for relief relating to hurricanes

1.3.1.1 Penalty-free withdrawals from retirement plans

The Katrina Emergency Tax Relief Act of 2005 allowed up to $100,000 in "qualified Hurricane Katrina distributions" from retirement plans to be exempt from the 10 percent early withdrawal penalty of Section 72(t).

A "qualified Hurricane Katrina distribution" is any distribution:

1. From an "eligible retirement plan" defined as:
   a) An IRA,
   b) An IRA annuity, other than an endowment contract,
   c) A Section 401(a) qualified trust,
   d) A Section 403(a) qualified annuity plan,
   e) A Section 457(b) eligible deferred compensation plan maintained by a governmental employer, and
   f) A Section 403(a) annuity contract.
2. Made on or after August 25, 2005 and before January 1, 2007,
3. To an individual whose principal place of abode on August 28, 2005, was located in the Hurricane Katrina disaster area, and
4. Who sustained an economic loss due to Hurricane Katrina.

Taxpayers are allowed to recontribute qualified Hurricane Katrina distributions to eligible retirement plans or IRAs tax-free at any time during the three-year period beginning on the day after the date of the distribution, with the aggregate amount of such recontributions limited to the aggregate amount of the qualified Hurricane Katrina distributions made to the taxpayer.

Taxpayers are also allowed to include qualified Hurricane Katrina distributions in taxable income on a pro-rata basis over the three taxable year period beginning with the year the distribution is received. Taxpayers are allowed to elect not to have the three-year income averaging provision apply.

> *Example.* Linda receives a $60,000 qualified Hurricane Katrina distribution during 2006 for personal living expenses. Unless Linda elects otherwise, the $60,000 distribution will result in $20,000 of income being reported in each of her 2006, 2007, and 2008 Forms 1040.

The Gulf Opportunity Tax Act of 2005 expanded the relief provided under the Katrina Emergency Tax Relief Act of 2005 in the case of

qualified Hurricane Katrina distributions to any "qualified hurricane distribution," which is defined to include distributions related to Hurricanes Rita and Wilma. A qualified hurricane distribution includes distributions that meet the definition of qualified Hurricane Katrina distributions under the Katrina Emergency Tax Relief Act of 2005, as well as any other distribution from an eligible retirement plan made on or after September 23, 2005, and before January 1, 2007, to an individual whose principal place of abode on September 23, 2005, is located in the Hurricane Rita disaster area and who sustained an economic loss by reason of Hurricane Rita.

A qualified hurricane distribution also includes a distribution from an eligible retirement plan made on or after October 23, 2005, and prior to January 1, 2007 to an individual whose principal place of abode on October 23, 2005 is located in the Hurricane Wilma disaster area and who sustained an economic loss by reason of Hurricane Wilma.

The total amount of qualified hurricane distributions that an individual can receive from all plans, annuities, or IRAs is $100,000.

1.3.1.2 Recontributions of withdrawals for home purchases cancelled due to hurricanes

The Katrina Emergency Tax Relief Act of 2005 allowed specific retirement plan or IRA withdrawals for home purchases that were cancelled due to Katrina to be repaid to a qualified plan or IRA tax-free and without penalty. Examples of such specific withdrawals include hardship distributions from a qualified plan to purchase a home or IRA withdrawals under the first-time homebuyer rule.

A qualified distribution amount must have been received by the taxpayer after February 28, 2005, and before August 29, 2005, with the distribution intended to be used to purchase or construct a principal residence in the Katrina disaster area, with the purchase or construction not occurring due to the Katrina disaster.

The Gulf Opportunity Zone Act expanded the provision under the Katrina Emergency Tax Relief Act of 2005, allowing recontribution of certain distributions from a 401(k) plan, 403(b) annuity, or IRA for qualified Hurricane Rita distributions and for qualified Hurricane Wilma distributions.

A qualified Hurricane Rita distribution is a hardship distribution from a 401(k) plan or 403(b) annuity, or a qualified first-time home buyer distribution from an IRA:

- That is received after February 28, 2005, and before September 24, 2005, and
- That was to be used to purchase or construct a principal residence in the Hurricane Rita disaster area, but the residence is not purchased or constructed on account of Hurricane Rita.

Any portion of a qualified Hurricane Rita distribution may, during the period beginning on September 23, 2005, and ending on February 28, 2006, be recontributed to a plan, annuity, or IRA to which a rollover is permitted.

A qualified Hurricane Wilma distribution is a hardship distribution from a 401(k) plan or 403(b) annuity, or a qualified first-time home buyer distribution from an IRA:

1. That is received after February 28, 2005, and before October 24, 2005, and
2. That was to be used to purchase or construct a principal residence in the Hurricane Wilma disaster area, but the residence is not purchased or constructed on account of Hurricane Wilma.

Any portion of a qualified Hurricane Wilma distribution may, during the period beginning on October 23, 2005, and ending on February 28, 2006, be recontributed to a plan, annuity, or IRA to which a rollover is permitted.

1.3.1.3 Loans from qualified plans relating to hurricanes

The Katrina Emergency Tax Relief Act of 2005 allowed amounts withdrawn as a loan from a qualified employer plan to be increased to the amount of $100,000 (normally $50,000) or the greater of $10,000 or the present value of the employee's nonforfeitable accrued benefit under the plan (normally the greater of $10,000 or one-half of the present value) for victims of Katrina. Additionally, a one-year postponement of payments for existing plan loans is allowed.

A qualified individual for purposes of this provision means an individual whose principal place of abode on August 28, 2005, was located in the Katrina disaster area and who sustained an economic loss by reason of Katrina. The special rules for loans from a qualified employer plan provided under the Katrina Emergency Tax Relief Act of 2005 were expanded to loans from a qualified employer plan to a qualified Hurricane Rita or Hurricane Wilma individual made on or after December 21, 2005, and before January 1, 2007.

A qualified Hurricane Rita individual includes an individual whose principal place of abode on September 23, 2005, is located in the Hurricane Rita disaster area and who sustained an economic loss by reason of Hurricane Rita. In the case of a qualified Hurricane Rita individual with an outstanding loan on or after September 23, 2005, from a qualified employer plan, if the due date for any repayment with respect to such loan occurs during the period beginning on September 23, 2005, and ending on December 31, 2006, the due date is delayed by one year.

A qualified Hurricane Wilma individual includes an individual whose principal place of abode on October 23, 2005, is located in the Hurricane Wilma disaster area and who sustained an economic loss by reason of Hurricane Wilma. In the case of a qualified Hurricane Wilma individual with an outstanding loan on or after October 23, 2005, from a qualified employer plan, if the due date for any repayment with respect to the loan occurs during the period beginning on October 23, 2005, and ending on December 31, 2006, the due date is delayed by one year.

An individual cannot be a qualified individual with respect to more than one hurricane.

1.3.1.4 Provisions relating to plan amendments

The Katrina Emergency Tax Relief Act of 2005 allowed a qualified plan or IRA to implement legislative or regulatory changes associated with Katrina relief without first having to amend the qualified plan or IRA itself.

The provision to make retroactive plan amendments under the Katrina Emergency Tax Relief Act of 2005, was expanded to apply to changes made pursuant to new Section 1400Q, dealing with the special rules for use of retirement funds described in Section 1.3.1, preceding.

1.3.2 Employment relief

1.3.2.1 Employee retention credit for employers affected by hurricanes

A new tax credit is added, computed as 40 percent of the first $6,000 of qualified wages per employee paid by an eligible employer to an eligible employee.

An eligible employer is one that conducted an active business on August 28, 2005, in the Katrina core disaster area and for whom the business is operable on any day after August 28, 2005, and before January 1, 2006 because of Katrina damage. But see the modification to this definition of an eligible employer, following.

Caution

The credit is only allowed for small businesses that employed an average of 200 or fewer employees on business days during the taxable year.

The Gulf Opportunity Zone Act of 2005 modified the provisions that were enacted in the Katrina Emergency Tax Relief Act of 2005 by eliminating the provision that restricted the credit to employees of not more than 200 employee.

Additionally, the employer retention credit, as modified to eliminate the employer size limitation, was extended to employers affected

by Hurricanes Rita and Wilma and located in the Rita Gulf Opportunity Zone and the Wilma Gulf Opportunity Zone, respectively. The reference dates for employers affected by Hurricane Rita and Hurricane Wilma, compared to the August 28, 2005, date for employers affected by Hurricane Katrina, are September 23, 2005, and October 23, 2005, respectively.

1.3.3 Charitable giving incentives

1.3.3.1 Temporary suspension of limitations on charitable contributions

The percentage limitation on charitable deductions was temporarily increased by the Katrina Emergency Tax Relief Act of 2005 for qualified contributions made in cash during a specified period. Additionally, such donations were not subject to the overall phase-out limit on Schedule A itemized deductions.

Individual taxpayers were allowed to deduct qualified contributions up to the amount by which the taxpayer's contribution base (that is, the taxpayer's adjusted gross income (AGI) subject to the normal percentage limitation) exceeds the taxpayer's deduction for other qualified charitable contributions.

Additionally, C corporations were allowed to deduct qualified disaster contributions up to the corporation's entire taxable income, less other contributions; however, contributions by C corporations must specifically have been for Katrina relief efforts.

Qualified contributions are cash contributions made during the period beginning on August 28, 2005, and ending on December 31, 2005, to a qualifying charity for which the taxpayer has elected qualified contribution treatment.

> *Example.* Charlie made $17,500 of qualified contributions and $15,000 of other contributions to qualified charities. Charlie's contribution base for 2005 is $25,000.
>
> Charlie was allowed to deduct $25,000 for 2005, an amount equal to his contribution base ($12,500 determined without regard to qualified contributions and $12,500 of qualified contributions). Charlie's carryover contribution amount of $7,500 ($5,000 from unused qualified contributions and $2,500 from unused regular contributions) carries forward to the next five years, subject to the normal 50 percent of AGI limit.

The temporary increase in the percentage limitation on charitable deductions for qualified contributions made in cash during a specified period, as enacted by the Katrina Emergency Tax Relief Act of 2005, was extended by the Gulf Opportunity Zone Act for qualified disaster

contributions made by C corporations up to the corporation's entire taxable income, less other contributions, to be allowed for contributions specifically for Katrina relief efforts and also for contributions for relief efforts related to Hurricane Rita and Hurricane Wilma.

2. S CORPORATION DEVELOPMENTS

2.1 Impact on Basis With Contribution of Appreciated Property

2.1.1 Background

Shareholders of an S corporation are able to deduct the shareholder's pro-rata share of a contribution made by the S corporation. The shareholders reduce their basis in the stock of the S corporation by the amount of the charitable contribution flowing through to their individual tax return.

Regarding the contribution of appreciated property, the IRS has issued several private rulings in the past clarifying that the stock basis of an S shareholder is reduced by the fair market value of any appreciated property contributed by the S corporation. (See PLRs 9340043, 9512002, and 9537018.) However, the IRS had separately ruled that in the case of a partnership contributing appreciated property, the partner reduced his or her basis in the partnership by only the partner's pro-rata share of the adjusted basis of the contributed property (see Rev. Rul. 96-11).

2.1.2 S shareholder treatment conforms to partner treatment

The Pension Protection Act of 2006 has enacted a provision such that when an S corporation contributes appreciated property, the shareholders of the corporation only reduce their pro-rata share of their basis by the adjusted basis of the property contributed. This change is effective for contributions made in taxable years beginning after December 31, 2005, and before January 1, 2008.

Observation

This change conforms the S corporation rules to the partnership rules regarding the impact on basis associated with the contribution of appreciated property by the pass-through entity.

2.2 Health insurance deduction for S corporation sole shareholders

2.2.1 Background

Self-employed taxpayers are allowed to deduct 100 percent of health insurance premiums for the taxpayer and the taxpayer's spouse and dependents in arriving at AGI. When an S corporation pays these premiums, the S corporation is treated as a partnership and any shareholder who owns more than 2 percent of the stock in the S corporation is treated as a partner of the partnership.

The IRS had previously ruled in Rev. Rul. 91-26 that health insurance premiums paid by a partnership on behalf of a partner are treated as guaranteed payments if the premiums are paid for services rendered in the capacity of a partner and to the extent the premiums are determined without regard to partnership income. With guaranteed payment treatment, the health insurance premiums become deductible by the partnership and includable in the recipient partner's gross income. Following this, health insurance premiums paid by an S corporation are not deductible by the corporation as a fringe benefit, but rather are deductible by the S corporation as compensation to the 2 percent shareholder and included in the Form W-2 wages of the shareholder. Because the shareholder is treated as a partner, the shareholder is then able to deduct the health insurance premiums paid by the S corporation in arriving at AGI, assuming all other requirements qualifying the taxpayer for the 100 percent self-employed health insurance deduction are met.

2.2.2 Health insurance purchased by S corporation sole shareholder

The IRS published guidance on its website in May, 2006 (IRS *E-news*, Headliner Volume 163), ruling that the sole shareholder of an S corporation, unlike the sole owner of a proprietorship, cannot purchase health insurance in the shareholder's individual name and deduct the premium in arriving at AGI. Rather, the IRS notes that such a shareholder can only deduct the health insurance as an itemized deduction on Schedule A, subject to the 7½ percent of AGI limit for medical expenses.

The IRS determined that the health insurance must be in the name of the corporation itself to qualify the individual for the 100 percent self-employed health insurance deduction. Accordingly, the IRS noted that the corporation itself must have a "plan" to provide the health insurance, thereby concluding that the insurance policy itself must be in the corporate name.

While informational releases on the IRS website do not carry binding authority, they are clearly indicative of the IRS position on various matters. Accordingly, taxpayers should attempt to comply with the IRS interpretation and purchase the health insurance policy in the name of the corporation. Where this is impossible or uneconomical, taxpayers should consider alternatively establishing a corporate plan, in writing, detailing a reimbursement policy of the corporation to the sole shareholder for any health insurance outlays paid by the shareholder. Also, where appropriate, clients should be warned of the risk of not having the insurance in the name of the corporation itself.

2.3 Schedule M-3 for S Corporations

2.3.1 Background

In 2004, the IRS released a Schedule M-3 for C corporations, used to better identify differences between financial accounting net income and taxable income for corporate taxpayers. Schedule M-3 is required to be completed and attached to Form 1120 by larger corporations with total assets of $10 million or more for any taxable year ending on or after December 31, 2004.

2.3.2 Schedule M-3 released for S corporations

The IRS has now released a draft of Schedule M-3 for S corporations, along with the related instructions to the form.

The Schedule M-3 will be required to be filed by S corporations with at least $10 million of total assets, effective for years ending on or after December 31, 2006. This Schedule M-3 requires a detailed reconciliation of income and expense differences as reported on the books of the corporation or financial statements of the corporation compared to what is reported in the Form 1120S.

If an S corporation subject to Schedule M-3 filing owns or is deemed to own, directly or indirectly, a 50 percent or greater interest in the income, loss or capital of a partnership, it becomes what is known as a reportable entity partner. A reportable entity partner must notify the partnership within 30 days of first becoming a reportable entity partner, and this then subjects the partnership itself to its own Schedule M-3 reporting.

The draft of the Schedule M-3 for S corporations and the related instructions can be found at the IRS website.

2.4 Impact on Shareholder Basis with Guarantees and Related Company Loans

2.4.1 Background

An S shareholder may only deduct pass-through losses from an S corporation to the extent of the shareholder's basis in the stock of the corporation and the basis of any debt of the S corporation for the shareholder. The courts have historically interpreted this as requiring a direct loan from the shareholder to the S corporation, as opposed to the guarantee of debt of the corporation by the shareholder. The courts have also generally ruled that when related entities controlled by the shareholder make loans into an S corporation, shareholder basis is not increased. Rather, the courts generally require that an actual economic outlay on the part of the shareholder occurs in connection with stock or debt basis.

2.4.2 Basis increase denied on circular loans

The Tax Court ruled that basis increase did not occur when loans were made to an S corporation by a related partnership (*Ruckriegel v. Comm.*, TC Memo 2006-78). The court analyzed the facts and determined that the taxpayers attempted to create an after-the-fact paper trail via corporate minutes and then used adjusting entries to attempt to achieve basis personally for the loan made by the related partnership to the S corporation. The court paid particular attention to the informal manner in which all of this occurred, finding that a direct economic outlay had not occurred and that shareholder basis was not increased.

2.4.3 Basis increase denied to real estate developer

The Tax Court ruled that a real estate developer could not increase basis in his S corporation related to the portion of a bank loan contributed to another corporation controlled by the taxpayer, finding that the taxpayer simultaneously moved the loan funds back to other corporations which he controlled, with ultimate repayment of the loan to the financial institution in less than two weeks from the date of the original loan (*Kaplan v. Comm.*, TC Memo 2005-218). The court again found that no true economic outlay had occurred, as the taxpayer failed to prove that a repayment to him by another corporation he controlled met the economic substance doctrine.

2.4.4 Back-to-back loans increases basis

The Tax Court ruled that a taxpayer did increase shareholder basis when the shareholder personally gave a fully recourse promissory note

to a bank, then in turn loaned the money to his S corporation, which in turn gave the shareholder a promissory note mirroring the terms of the note to the bank (*Miller v. Comm.*, TC Memo 2006-125).

The IRS attempted to argue that the steps of the individual borrowing from the bank and lending to the corporation should be disregarded, with the transaction treated as a loan directly from the bank to the corporation, thereby denying shareholder basis. However, the court found that the shareholder had a legitimate and separate identity as a borrower from the bank and lender to the corporation.

Observation

The IRS challenge of this approach of the taxpayer is somewhat surprising, as this strategy of the taxpayer is one that has been long recommended by many professionals. Namely, to increase shareholder basis, a shareholder needs to personally borrow from the bank and then subsequently loan the funds to the corporation.

2.4.5 Loan guarantee does not increase stock basis

The Sixth Circuit has upheld a Tax Court decision, finding that basis was not increased by the amount of a loan made by a bank directly to the S corporation (*Maloof v. Comm.*, CA-6, 8/8/2006, aff'g. TC Memo 2005-75).

The taxpayer attempted to argue that the personal guarantee of the corporation loan was an event that should result in an increase in shareholder basis. However, determining that the loan went directly from the bank to the S corporation and not to the individual shareholder, the court disagreed.

2.4.6 Circular loans did not increase basis

In a private ruling, the IRS determined that circular loans made to an S corporation from a partnership controlled by the corporate shareholders did not provide increased debt basis for the shareholders (TAM 200619021). The partnership had loaned money to the taxpayers over the course of several years. The taxpayers in turn loaned the money to the S corporation, which then paid rent to the partnership for use of partnership property. While notes were drafted for the loans, no repayments of either principal or interest were ever made on the notes.

In concluding that basis was not increased, the IRS found that the transfer of the funds was basically equivalent to offsetting bookkeeping entries. That is, there was no change in the economic positions of the parties after the transactions were complete. Also, the lack of any repayment of any principal or interest on the notes raised serious questions as to the legitimacy of the transactions.

In the same private ruling, the IRS noted that although the taxpayers had completed similar transactions and deducted losses in taxable years that were now closed by statute, the basis of the shareholders needed to be adjusted in the open years based on all losses previously deducted, even though some of those losses were in excess of actual basis in previous closed years.

2.5 Distributions from S Corporations With No AE&P

2.5.1 Background

S corporations with no accumulated earnings and profits (AE&P) can make distributions to shareholders in a nontaxable manner to the extent of shareholder stock basis. Any distributions in excess of stock basis are capital gain from the deemed distribution of stock.

Stock basis is adjusted for pass-through items and distributions in the following order:

- Increase by pass-through items of income and gain.
- Decrease by distributions, other than distributions of AE&P.
- Decrease by pass-through items of loss and deduction.

S corporations with no AE&P make distributions under a two-tier system, as follows:

- A nontaxable return of capital to the extent of the adjusted basis of stock, followed by
- Capital gain from the deemed disposition of stock

2.5.2 Suspended losses and current year income and distributions

If an S corporation with no AE&P makes a distribution less than its current income, and the shareholder has suspended loss carryovers, the suspended loss carryover to the current year is treated as a current year deduction. Accordingly, a shareholder first increases basis for income items, then decreases basis by the amount of any distribution, and finally decreases basis by the suspended loss carryover, which is considered a current year loss under Section 1366(d)(2).

Example. X is an S corporation owned by Jim. X has no AE&P. Jim has a $50,000 suspended loss carryover because of insufficient basis in prior years. For the current year, Jim is allocated income of $15,000 and received a distribution of $2,500. Jim's beginning stock basis is zero because his

losses to the extent of basis were deducted in prior years. Jim first increases his basis by the $15,000 of income, then decreases basis by the $2,500 of distributions received during the year. The remaining basis of $12,500 is reduced to zero using a portion of the $50,000 suspended loss carryover, which is considered a current year loss. As such, the $2,500 distribution is tax-free because Jim has adequate basis in the current year. However, Jim needs to pick up $15,000 of income on his individual tax return, while only being able to deduct $12,500 of the suspended loss carryover. Jim still has $37,500 of suspended loss carryover at the end of the year.

2.6 Members of Family as One Shareholder

A family may elect to have all family members treated as one shareholder for purposes of the 100-shareholder limit on the number of S corporation shareholders. The election is available whether the family member holds the stock directly or is treated as a shareholder because the individual is a beneficiary of a QSST or an ESBT.

Family members include the common ancestor, lineal descendants of the common ancestor, and the spouses (or former spouses) of such lineal descendants or common ancestor. However, an individual is not considered a common ancestor if, as of the later of the date of enactment or the time the election is made, the individual is more than six generations removed from the youngest generation of shareholders who would (but for this limitation) be members of the family. A spouse or former spouse is treated as being of the same generation as the individual to whom the spouse is (or was) married. Additionally, an adopted child or foster child is treated as a natural child if the requirements of Section 152 are satisfied.

The election may be made by any member of the family, except where prohibited by IRS regulations, and remains in effect until terminated in a manner to be prescribed by the IRS via regulations.

As with other inadvertent invalid elections or terminations, the IRS is granted the authority to waive an inadvertently invalid election or an inadvertently invalid termination of such an election.

The provision is effective for taxable years beginning after December 31, 2004, and the inadvertent invalid election or termination relief is available for elections and terminations made after December 31, 2004 [Act Sec. 231, amending Sections 1361(c) and 1362(f)].

Law Change Alert:

The requirement to make an election to treat all members of the family as one shareholder was repealed by Act Sec. 231 of the Gulf Opportunity Zone Act of 2005, amending Section 1361(c). Such treatment is now automatic.

2.7 Grandfathered IRAs Allowed to Hold Bank S Stock

In general, IRAs and Roth IRAs are not permitted as S corporation shareholders. An IRA or Roth IRA is allowed to hold shares of an S corporation that is a bank (per the definition in Section 581) if the shares were held in the IRA or Roth IRA on October 22, 2004. If the IRA or Roth IRA holds the bank S stock, the individual for whose benefit the IRA or Roth IRA was created is treated as the shareholder. Additionally, the UBTI rules applying to other tax-exempt entities (other than employee stock option plans (ESOPs)) apply to IRAs and Roth IRAs holding S corporation stock.

The prohibited transaction rules do not apply to the sale of stock by an IRA or Roth IRA to the individual beneficiary of the trust if:

1. The stock is stock in a bank (per the definition in Section 581),
2. The stock is held by the IRA or Roth IRA as of October 22, 2004,
3. The sale is pursuant to an S election by the bank,
4. The sale is for fair market value at the time of sale (as established by an independent appraiser) and the terms of the sale are otherwise at least as favorable to the IRA or Roth IRA as the terms that would apply for a sale to an unrelated party,
5. The IRA or Roth IRA does not pay any commissions, costs, or other expenses in connection with the sale, and
6. The stock is sold in a single transaction for cash not later than 120 days after the S election is made.

The provision is effective on October 22, 2004 [Act Sec. 233, amending Sections 512(e)(1), 1361(c)(2), and 4975(d)].

Law Change Alert:
The provision allowing grandfathered IRAs to hold bank S stock was amended by the Gulf Opportunity Zone Act of 2005 to also allow such grandfathered IRAs to also hold bank holding company stock [Act Sec. 233 of the Gulf Opportunity Zone Act of 2005, amending Section 1361(c)(2)(A) and Section 4975(d)].

2.8 Transfer of Suspended S Corporation Losses to Spouse or Former Spouse

Where a tax-free Section 1041(a) transfer of S stock to a spouse or former spouse incident to divorce occurs, any disallowed losses or deductions are carried over to the spouse or former spouse and are treated

as incurred by the corporation in the succeeding taxable year with respect to the transferee.

The provision is effective for taxable years beginning after December 31, 2004 [Act Sec. 235, amending Section 1366(d)(2)].

Observation
Prior to this change, any loss not deducted by an S shareholder due to the lack of basis in stock and debt was carried forward, but was allowed in subsequent years only "with respect to that shareholder." The suspended loss did not transfer with the stock (see PLR 9552001).

Law Change Alert:
The provision was amended by Act Sec. 235 of the Gulf Opportunity Zone Act of 2005 to change the effective date from "taxable years beginning after December 31, 2004" to "transfers after December 31, 2004."

2.9 Banks and Passive Investment Income

For a bank (as defined in Section 581), a bank holding company or a financial holding company, passive investment income (for purposes of the test in determining whether passive investment income exceeds 25 percent of gross receipts for three consecutive taxable years, resulting in involuntary termination of S status and a tax under Section 1375) does not include:

1. Interest income earned by the bank, bank holding company, or financial holding company, or
2. Dividends on assets that must be held by the bank or company, including stock in the Federal Reserve Bank, the Federal Home Loan Bank, or the Federal Agricultural Mortgage Bank, or participation certificates issued by a Federal Intermediate Credit Bank.

The provision applies to taxable years beginning after December 31, 2004 [Act Sec. 237, amending Section 1362(d)(3)].

Law Change Alert:
This provision was amended by Act Sec. 237 of the Gulf Opportunity Zone Act of 2005 to extend the same rules to bank holding companies [Act Sec. 237 of the Gulf Opportunity Zone Act of 2005, amending Section 1362(d)(3)].

2.10 Interest Rate on S Corporation Refunds

2.10.1 Background

Generally, interest paid on tax overpayments by a corporation uses the federal short-term rate, plus 2 percent. However, to the extent a tax payment of a corporation exceeds $10,000, the interest rate is reduced to the federal short-term rate, plus ½ percent [Section 6621(a)].

Observation
Under Section 6621(a)(1)(D), individual taxpayers are entitled to an interest rate equal to the federal short-term rate, plus 3 percent.

2.10.2 Interest rate applying to overpayment of built-in gains tax

In a fully reviewed Tax Court decision, the court found that an S corporation was entitled to an interest amount on a refund associated with the overpayment of built-in gains tax equal to the federal short-term rate, plus 2 percent, on the amount in excess of $10,000 (*Garwood Irrigation Co. v. Comm.*, 126 TC No. 12, 5/1/2006). The IRS had attempted to argue that the federal short-term rate plus ½ percent applied to large corporate overpayments for both C and S corporations. However, the court found that the lower rate only applied to C corporations, using the language of the Committee Report in determining that the higher interest rate applied to the S corporation overpayment.

3. DEPRECIATION AND AMORTIZATION

3.1 Section 179 Expensing

3.1.1 Background

Generally, businesses can elect under Section 179 to deduct all or part of the cost of certain qualifying property in the year the property is placed in service. This is in lieu of taking depreciation deductions over a specified recovery period. However, there are limits on the amount that can be deducted in a tax year. This benefit is not available to estates and trusts. Taxpayers can claim the expensing deduction only on qualifying Section 1245 property bought for use in their trade or business. They cannot claim the deduction on property they hold only for the production of income.

3.1.2 Maximum annual Section 179 deduction

The maximum annual deduction under Section 179 is as follows:

Tax Year Beginning in	*Maximum Expense Deduction*
2002	$ 24,000
2003	100,000
2004	102,000
2005	105,000
2006	108,000

3.1.3 Extension of dollar amounts through 2009

The 2003 Tax Act increased the maximum dollar amount that may be deducted under Section 179 to $100,000 for property placed in service in taxable years *beginning* in 2003, 2004, and 2005 [Section 179(b)(1)]. The 2004 Jobs Act subsequently extended this enhanced Section 179 deduction through tax years beginning in 2007. The Tax Increase Prevention and Reconciliation Act of 2005 once again extended this enhanced Section 179 deduction through tax years beginning in 2009. Also, for these same years, the $100,000 amount is subject to inflation-indexing.

Also, for tax years beginning in 2003 through 2009, the threshold for the phase-out of the eligible Section 179 deductible amount is increased from $200,000 to $400,000. For tax years beginning in 2006, the threshold has been inflation-indexed to $430,000 (Rev. Proc. 2005-70).

3.1.4 Electing Section 179 on an amended return

In the Committee Report accompanying the American Jobs Creation Act of 2004, Congress indicated its expectation that the IRS will prescribe regulations to permit a taxpayer to make a Section 179 election on an amended return without IRS consent. This expression of congressional intent was part of the Act extending the enhanced $100,000 Section 179 deduction to tax years beginning before 2008, and presumably indicated congressional intent for the amended election opportunity to also be extended two years to cover property placed in service in tax years beginning before 2008 (Comm. Rpt. P.L. 108-357, Act Sec. 201).

The IRS then issued final regulations extending the privilege to elect Section 179 expensing on an amended return for two additional years (2006 and 2007), resulting in all current Section 179 provisions being extended through 2007 (Reg. Section 1.179-5, T.D. 9209, 7/13/2005). It is expected this regulation will again be modified to

extend the provision through 2009, to conform with the statutory provisions described above.

3.2 Energy Efficient Commercial Building Expensing

3.2.1 Background

No provision previously existed for expensing of energy-efficient commercial building property.

3.2.2 First-year deduction for energy-efficient building property

The 2005 Energy Tax Act (enacted August 8, 2005) added a new first-year deduction for energy-efficient commercial building property. This deduction applies to property placed in service after December 31, 2005, and before January 1, 2008 (Section 179D).

3.2.2.1 Eligible improvements

A deduction under Section 179D can be claimed for energy-efficient commercial building property, defined as:

- Property for which depreciation or amortization is allowable,
- Which is installed on or in a building located in the United States,
- Within the scope of Standard 90.1-2001 of the American Society of Heating, Refrigerating, and Air Conditioning Engineers and the Illuminating Engineering Society of North America,
- Which is installed as part of the interior lighting systems, heating and cooling ventilation and hot water systems, or the building envelope, and
- Which is certified as installed as part of a plan to reduce the annual energy and power costs with respect to the interior lighting systems, heating, cooling, ventilation and hot water systems of the building by 50 percent or more in comparison to a referenced building which meets the minimum requirements of Standard 90.1-2001, using methods of calculation to be prescribed by the IRS [Section 179D(c)(1)].

3.2.2.2 Deduction limits

The deduction for any building for any tax year cannot exceed the product of $1.80 multiplied by the square footage of the building, reduced by any deductions claimed under this provision for that building for any prior tax years. For example, if a commercial building

has a size of 100,000 square feet, the maximum Section 179D energy improvement deduction that can be taken cumulatively for the building is limited to $180,000.

A lower limit applies if the building fails to meet the 50 percent reduction in energy and power cost target. In this case, if there is a certification that any qualifying energy improvement component (for example, lighting, heating, cooling, ventilation, hot water, or building envelope) satisfies IRS-approved energy saving targets, a deduction is allowed for that component, limited to $.60 per square foot of building space, again on a cumulative basis.

3.2.2.3 Certification and calculation of energy savings

The certification of a plan of 50 percent energy reduction for a building, or alternatively the certification of a specific component, is to be accomplished in a manner and method as prescribed by IRS regulations. However, the statute requires the IRS to consult with the Secretary of Energy, and base the standards on the 2005 California Nonresidential Alternative Calculation Method Approval Manual. Further, the calculation under this methodology must be prepared by qualified computer software, for which the software designer has certified that the software meets all procedures and methods for calculating energy and power consumption and costs as required by the IRS, and which provides forms as required by the IRS in connection with the energy efficiency of property. The certification is required under Section 179D, and would provide a notice form which documents the energy efficient features of the building and its projected annual energy costs [Section 179D(d)(3)].

3.2.2.4 Allocation for governmental property

If energy efficient commercial building property is installed in a building owned by a federal, state, or local governmental entity or subdivision, the statute allows the deduction to be allocated to the person primarily responsible for designing the property, rather than to the owner of the property [Section 179D(d)(4)].

Observation

As a result of this provision, building contractors and design firms that are responsible for designing energy improvements to state, city, county, or school district buildings will qualify for the energy deduction, as if they were the taxpayer that owned the building.

3.2.2.5 Recapture

The Section 179D deduction represents a reduction in the tax basis of the property prior to any cost recovery or depreciation. Further, for

purposes of Section 1245 ordinary income depreciation recapture, any Section 179D commercial building expensing is treated as depreciation subject to recapture [Section 1245(a)(2)(C)].

3.2.2.6 Guidance on qualification for deduction

The IRS has established the process to certify the energy savings for a taxpayer to claim the energy efficient commercial building expensing deduction (IRS Notice 2006-52, IRB No. 2006-26). The certification must be obtained by a taxpayer prior to claiming the deduction. The certification need not be attached to the tax return of the taxpayer claiming the deduction, but the taxpayer should retain the certification as part of the taxpayer's books and records.

The certification must be provided by a qualified individual, generally defined as an unrelated individual who is a licensed professional engineer or contractor in the specific area in which the building is located. Additionally, the qualified individual must represent to the taxpayer, in writing, that the individual possesses the necessary skills and experience to provide the certification.

In the same guidance, the IRS announced that the Department of Energy is creating and will maintain a public list of software that must be used to calculate the energy savings for purposes of providing the certification. Also, the IRS announced that buildings that fail to meet the 50 percent reduction in energy and power cost target to qualify for the $1.80 per square foot deduction must achieve a 16⅔ percent energy savings reduction to qualify for the lower $.60 per square foot deduction.

3.3 Bonus Depreciation for Long Production Period Property and Noncommercial Aircraft

3.3.1 Background

Bonus depreciation of 30 percent and 50 percent was allowed on qualified property placed in service from September 11, 2001, through December 31, 2004 [Section 168(k)]. Special transitional rules also apply, allowing bonus depreciation for property placed in service through the end of 2005 for specified property.

Noncommercial aircraft could qualify for the extended placed-in-service date for purposes of 50 percent bonus depreciation, but such aircraft needed to meet the following criteria:

- The aircraft must have been acquired between September 11, 2001, and December 31, 2004.

- The aircraft must have been placed in service prior to January 1, 2006.
- The aircraft may not have been tangible personal property used in the trade or business of transporting persons or property, except for agricultural or firefighting purposes.
- The aircraft must have been purchased by a taxpayer, who at the time of the contract or purchase, had made a nonrefundable deposit of the lesser of 10 percent of the cost or $100,000.
- The aircraft must have had an estimated production period exceeding four months and a cost exceeding $200,000.

A similar transition rule provided the 30 percent/50 percent bonus depreciation through December 31, 2005, for qualifying longer production period property, as defined in Section 168(k)(2)(B).

3.3.2 Placed-in-service date extended for hurricane areas

The IRS has extended for one year, until December 31, 2006, the deadline for specified Hurricane-impacted taxpayers to place property in service to claim the first-year bonus depreciation (IRS Ann. 2006-29, IRB No. 2006-19).

Observation

Taxpayers impacted by Hurricane Katrina, Hurricane Rita, or Hurricane Wilma have the extended period to place property in service in order to claim the 50 percent bonus depreciation. However, such taxpayers must be able to prove that they were unable to meet the original December 31, 2005, placed-in-service deadline because of the hurricane-related event.

The IRS has released Publication 4492, *Information for Taxpayers Affected by Hurricanes Katrina, Rita and Wilma,* which describes the disaster areas that comprise the Gulf Opportunity Zone, the Rita Gulf Opportunity Zone, and the Wilma Gulf Opportunity Zone.

4. ACCOUNTING METHOD CHANGES

4.1 Twelve-month Prepaid Expense Rule

4.1.1 Background

Under the final regulations regarding capitalization of intangibles, taxpayers are not required to capitalize amounts, including transaction

costs, paid to create or enhance intangible rights or benefits that do not extend beyond the earlier of 12 months after the first date on which the taxpayer realizes the benefit or the end of the tax year following the year in which payment is made [Reg. Section 1.263(a)-4(f)]. However, this 12-month rule does not permit an accrual method taxpayer to deduct an amount prepaid for goods and services where the amount has not been incurred under the Section 461(h) economic performance rules. Also, the 12-month rule is not applicable to assets that represent Section 197 amortizable intangibles nor to a created financial interest described in Reg. Section 1.263(a)-4(d)(2).

Example. On December 1, 2005, N Corporation pays a $10,000 insurance premium for a property insurance policy with a one-year term beginning on February 1, 2006. Because the right attributable to the $10,000 payment extends beyond the end of the taxable year following the taxable year in which the payment is made, the 12-month rule does not apply and N is required to capitalize the $10,000 payment.

Assume the same facts, except the policy has a term beginning on December 15, 2005. The 12-month rule now applies because the right attributable to the payment neither extends more than 12 months beyond December 15, 2005 (the first date the benefit is realized by the taxpayer), nor beyond the taxable year following the year in which the payment is made. Accordingly, N is not required to capitalize the $10,000 payment [Reg. Section 1.263(a)-4(f)(8), Examples 1 and 2].

4.1.1.1 Coordination with economic performance rules

In general, the economic performance rules require that an accrual method taxpayer may not claim a deduction until an expense has met the "all events" test and economic performance has occurred with respect to the liability [Section 461(h)]. In general, economic performance occurs as the property or services are provided to the taxpayer. A prepayment for goods or services is treated as economic performance, provided the services are rendered or the goods are provided no more than three and one-half months after payment [Reg. Section 1.461-4(d)]. With respect to an accrual for the rental of property, economic performance is considered to occur ratably over the period covered by the lease or other agreement [Reg. Section 1.461-4(d)(3)].

Example. U Corp leases office space at a monthly rate of $2,000. On August 1, 2006, U Corp prepays its office rent for the first six months of 2007 in the amount of $12,000. If U Corp is an accrual method taxpayer and subject to the economic performance rules, economic performance is not considered to occur until 2007. Accordingly, U Corp may not use the twelve-month rule to deduct its prepaid rent because economic performance has not occurred with respect to the rent prepayment.

Alternatively, if U Corp was a cash method taxpayer, then the economic performance rules of Reg. Section 1.461-4 do not apply. Accordingly, U Corp's prepayment of rent of $12,000 qualifies under the twelve-month rule and may be deducted in 2006.

Observation

The 12-month rule has greatest application for accrual method taxpayers who are now permitted to prepay an expense which does not have a benefit extending beyond 12 months, thereby permitting a current deduction. However, to avoid the disallowance of this prepaid expense under the economic performance rules, the prepaid expenditure will typically need to relate to an item for which payment is considered to be economic performance under Reg. Section 1.461-4. Expenditures where payment is considered to be economic performance and for which an immediate deduction for a prepaid expense will now be allowable to an accrual method taxpayer include insurance, taxes and licensing fees.

4.1.1.2 Previous guidance on accounting method change request

A taxpayer desiring to change a method of accounting to comply with Reg. Section 1.263(a)-4, such as an accrual method taxpayer seeking to utilize the 12-month rule, must secure the consent of the IRS to accomplish the accounting method change [Reg. Section 1.263(a)-4(p)]. However, for the taxpayer's first taxable year ending on or after December 31, 2003, a taxpayer was granted permission to use the automatic consent procedures to an accounting method change (Rev. Proc. 2004-23, IRB No. 2004-16). This Revenue Procedure covered tax years ending December 31, 2003 through November 30, 2004.

4.1.2 Extension of automatic accounting method request

The IRS subsequently provided a one-year extension for making the automatic consent accounting method change to adopt the 12-month prepaid expense rule as an accrual method taxpayer (Rev. Proc. 2005-9, IRB No. 2005-2). This extension of the automatic consent procedures applied to tax years ending December 31, 2004 through November 30, 2005. Rev. Proc. 2005-9 clarified that a separate election must be made for each prepaid category (e.g., prepaid insurance, prepaid service contracts, etc.), although apparently these elections to adopt the 12-month prepaid rule can all be made on a single Form 3115 that is attached to the tax return for the year of the change.

Observation

These automatic consent procedures allowed a taxpayer to accomplish an accounting method change by attaching a Form 3115 to a timely filed return. Unfortunately, for taxpayers who missed the opportunity to make an automatic change for the first or second tax year ending on or after December 31, 2003, a more formal nonautomatic accounting method change was required. In these cases, the Form 3115 must be filed during the tax year (rather than with the tax return), and a user fee will be assessed (see Rev. Proc. 2005-1).

4.1.3 Automatic accounting method change opportunity again extended

The IRS has once again extended the automatic accounting method change opportunity for the 12-month prepaid rules in Rev. Proc. 2006-12 (IRB No. 2006-3). Under the new guidance, the timing deadline is totally removed for making the automatic 12-month prepaid accounting method change, effective foı taxable years ending December 31, 2005, and after. However, an accounting method change to adopt the three and one-half month prepaid rule requires the filing of a nonautomatic Form 3115, including payment of a user fee. However, as a matter of convenience, the IRS announced that taxpayers filing a nonautomatic Form 3115 to adopt the three and one-half month prepaid rule could request the 12-month prepaid rule on the same Form 3115 (Rev. Proc. 2006-37, IRB No. 2006-38).

Observation

New accrual method taxpayers are not required to make an accounting method change. Rather, they are allowed to simply apply the new 12-month prepaid expense rules. Also, taxpayers are allowed to adopt the prepaid method even if nothing has been previously capitalized as prepaid amounts (i.e., the resulting Section 481(a) adjustment is zero).

4.2 Cash Advances: When Are They Taxable?

4.2.1 Background

Taxpayers must include an item of income in gross receipts in the taxable year in which it is received, unless, under the accounting method used in computing taxable income, the amount can be accounted for in a different period. Accrual method taxpayers are required to include amounts in gross income when all the events have occurred fixing the right to receive the income and the amount can be determined with

reasonable accuracy. Cash method taxpayers include an amount in gross income when the dollars are actually or constructively received.

4.2.2 Ninth circuit allows deferred reporting of income on cash advances

In reversing a Tax Court decision, the Ninth Circuit has ruled that cash advances paid to an accrual method taxpayer in exchange for the recipient to commit to specified volume purchase levels did not result in taxable income to the recipient upon receipt of the funds (*Westpac Pacific Foods v. Comm.*, CA-9, 6/21/2006, rev'g. TC Memo 2001-175).

The recipient treated the cash advance as a liability, similar to a loan. In exchange for the cash advance, the recipient promised to purchase a minimum quantity of merchandise and to receive a volume discount, represented by the cash advance. If the recipient purchased too few items, a repayment of a portion of the cash advance was required. Alternatively, a purchase of the committed volume of product allowed the recipient to retain the cash advance.

The Tax Court had previously ruled that the advances represented taxable income, relying on a previous U.S. Supreme Court decision in *Glenshaw Glass Co.* (348 U.S. 426, 1955). The Supreme Court ruled in that decision that the payments represented income because they were "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."

However, the appellate court reversed the lower court, finding that the taxpayer was obligated to meet the specified volume purchase commitment or repay a portion of the advance, resulting in the advance taking on more the form of a loan than actual income. Simply, the appellate court found there was no "accession to wealth" on receipt of the funds and thus allowed deferral of the taxable income recognition until the volume discount was realized.

In its opinion, the Ninth Circuit used a couple analogies to arrive at its decision. Quoting from the Ninth Circuit decision:

> "It is hard to think of a way to make money by buying things. A child may think buying things is how one makes money: He sees his father give a clerk a single piece of paper money, and receive in exchange the goods purchased, several pieces of paper money, and a number of coins. And a person may jokingly say to a spouse 'I made $100 today' after buying something on sale for $100 off. Yet everyone knows these are merely amusing remarks, not real ways to make money."

> "Harry Homeowner goes to the furniture store, spots just the right dining room chairs for $500 each, and says 'I'll take four, if you give me a discount.' Negotiating a 25 percent discount, he pays only $1,500 for the

chairs. He has not made $500, he has spent $1,500. Now suppose Harry Homeowner is short on cash, and negotiates a deal where the furniture store gives him a 20 percent discount as a cash advance instead of the 25 percent off. This means the store gives him $400 'cash back' today, and he pays $2,000 for the four chairs when they are delivered shortly after the first of the year. Harry cannot go home and say 'I made $400 today' unless he plans to skip out on his obligation to pay for the four chairs. Even though he receives the cash, he has not made money by buying the chairs. He has to sell the chairs for more than $1,600 if he wants to make money on that. The reason why the $400 'cash back' is not income is that, like a loan, the money is encumbered with the repayment obligation to the furniture store and the 'cash back' must be repaid if Harry does not perform his obligation."

"A company would indeed have a major problem if it accounted to its shareholders as the Tax Court would have it account to the government. Were a company to get very significant amounts of upfront cash discounts on its obligation to purchase goods in the future and tell stockholders and prospective stockholders that it had 'made' this much 'income,' investors would be sorely disappointed to learn that all the money had to be paid back if the company did not sell all the goods it had promised to sell in the future. The company would be like Harry Homeowner claiming to have 'made' $400 when he received his cash advance discount on the four chairs. Harry might have to spend the night on the couch, but the CEO could spend the night in jail."

4.3 Miscalculation of LIFO

4.3.1 Background

The IRS has provided a simplified set of procedures for a taxpayer to obtain automatic consent to change a method of accounting (Rev. Proc. 2002-9, IRB No. 2002-3). Automatic accounting method changes made under Rev. Proc. 2002-9 gained three advantages:

- No user fee is required to be paid to the IRS.
- The Form 3115, *Change in Accounting Method,* may be filed anytime during the year up to the filing date, including extensions, of the tax return for the year changed.
- A simplified four-year spread is provided for the Section 481(a) adjustment resulting from the accounting method change.

The IRS later announced that a negative Section 481(a) adjustment could be claimed entirely in the year of change, if the amount is a negative amount (Rev. Proc. 2002-19, IRB No. 2002-13). If the adjustment is positive, it may be spread equally over four years, or upon the

election of the taxpayer, claimed entirely in one year if the net positive change is under $25,000.

4.3.2 Ten-year miscalculation of LIFO

The Tax Court ruled that a ten-year deviation from the proper calculation of the LIFO ending inventory required a change in accounting method to change to the proper method of inventory valuation (*Huffman v. Comm.*, 126 TC No. 17, 5/16/2006).

The accountant had missed an important step in computing the proper LIFO inventory valuation and upon audit, the IRS required the taxpayer to make an accounting method change. The taxpayer attempted to argue that the problem was simply due to a mathematical error which did not rise to the level of a change in accounting method, but the Tax Court agreed with the IRS that a timing error was involved which was material in nature and which required a change in accounting method to correct.

4.4 Deductibility of Mold Removal

In a private ruling, the IRS has ruled that the cost of removing a mold condition in a building represented a current expense rather than a capital expenditure, determining that the mold condition was not present upon the purchase of the building and the removal of the mold condition did not adapt the building to a new or different use (PLR 200607003).

4.5 Valued-added Payments from Agricultural Cooperatives

The Eighth Circuit upheld a Tax Court decision, finding that a farmer was subject to constructive receipt of year-end value-added payments in the year an agricultural cooperative received payments (*Scherbart v. Comm.*, CA-8, 7/5/2006, aff'g. TC Memo 2004-143).

The taxpayer was a member of Minnesota Corn Processors (MCP), an agricultural cooperative producing ethanol from corn. MCP made value-added payments to the taxpayer subsequent to the end of each of the required annual corn delivery periods, and also made discretionary year-end value-added payments determined after the close of the fiscal year of MCP, which was September 30.

While the taxpayer required that the value-added payments be deferred until the following January, the courts found that the taxpayer

had the option of taking the value-added payment and thus that constructive receipt occurred.

While the taxpayer consistently deferred the year-end value-added payments to the next year, the courts found it was the taxpayer's decision solely to defer the payments and that the agreement to defer was between the taxpayer and MCP.

4.6 Capitalization of Repairs and Tangible Property Expenditures

4.6.1 Background

Incidental repairs which neither materially add to the value of property nor appreciably prolong its life are allowed as a current deduction. However, expenditures that represent permanent improvements, or that increase the value of property, restore its value, substantially prolong its useful life, or adapt the property to a new or different use must be capitalized.

4.6.2 IRS issues proposed regulations on capitalization of expenditures

The IRS has now issued proposed regulations addressing several issues associated with the capitalization of tangible property expenditures related to the issue of deductible repair and maintenance expenses [Prop. Regs. Sections 1.263(a)-0 through 1.263(a)-3, 8/18/2006]. Taxpayers are not allowed to request a change in accounting method to use the rules of the proposed regulations; rather, the regulations will only apply to taxable years beginning after publication as final regulations.

Generally, the guidance provides that an amount paid for the acquisition or production of a unit of property with an economic useful life of twelve months or less is not a capital expenditure and need not be capitalized. Correspondingly, any gain realized upon the disposition of such property is treated as ordinary income. However, under the proposed guidance, the twelve-month rule does not apply to property acquired for resale, nor to improvements to land or to another unit of property.

No guidance is provided allowing a deduction of de minimis amounts. However, the IRS requested comments as to whether the final regulations should contain such a de minimis rule. Such a de minimis rule would allow expenditures below a specified dollar amount to automatically be deducted.

The proposed regulations do address the so-called "unit of property" rule, under which a determination is made as to whether an expenditure materially increases the value of the property. For taxpayers operating in regulated industries, the proposed regulations require the taxpayer to use the same unit of property for federal tax purposes as is used under the industry uniform system of accounts. A building and its structural components must generally be treated as one unit of property, with a consistency requirement introduced when a component of a separate unit of property, such as in a cost segregation study, is used for depreciation purposes. For personal property, a facts and circumstances test is proposed to determine a unit of property, whereas for real property, a category is primarily land and land improvements.

Observation

Recent litigation has highlighted the importance of the unit of property rules. In *FedEx Corp.* (CA-6, 2/16/2005), the appellate court found that the entire aircraft, as opposed to the aircraft engine, was the appropriate unit of property, resulting in an expenditure qualifying as a repair because the amount was a smaller percentage of the total value of the property.

Under the proposed regulations, expenditures that materially increase the value of a unit of property must be capitalized, with the guidance providing a list of five tests for determining whether a material increase in value had occurred. The proposed regulations also introduce an optional repair allowance method, with the repair allowance amount equal to the taxpayer's average unadjusted basis in a property class multiplied by a percentage, with the percentage derived by dividing 100 percent by the number of years in the MACRS class and dividing by two.

Example. ABC has total unadjusted basis of 10-year MACRS property at January 1 of $100,000 and at December 31 of $150,000. ABC pays $10,000 during the year to repair or improve its 10-year property assets. The repair allowance percentage under the proposed regulations for 10-year property is 5 percent, computed by dividing 100 percent by 10, which is then divided by 2. ABC's repair allowance is based on its average unadjusted basis of 10-year property of $125,000, which is multiplied by 5 percent to produce a $6,250 repair allowance for the year. Accordingly, of the $10,000 of expenditures made during the year, ABC may deduct $6,250 as repairs and is required to capitalize the remaining $3,750.

5. COMPENSATION, RETIREMENT PLAN AND FRINGE BENEFIT ISSUES

5.1 Roth Elective Deferral Plans

5.1.1 Background

Effective for tax years beginning after 2005, new Section 402A permits employee elective deferral contributions to Section 401(k) plans and Section 403(b) tax-sheltered annuities to be categorized as an after-tax Roth account rather than a traditional pre-tax elective deferral (Section 402A, added by 2001 P.L. 107-16, effective for tax years beginning after December 31, 2005). In addition, in March of 2005, the IRS issued Proposed Regulations explaining the new Roth elective deferral opportunity (REG-152354-04, 3/2/2005) and then issued Final Regulations in December of 2005 (T.D. 9237, 12/30/2005).

5.1.2 IRS guidance on Roth elective deferral plans

Key points regarding the Roth elective deferral accounts include:

1. Each employee has the elective ability to designate their salary-reduction deferral in either a Section 401(k) or Section 403(b) plan as a Roth account, assuming that the employer has modified the plan to accept Roth contributions. A separate account must be maintained by the plan for the Roth contributions, and the plan must keep separate records for each participant's Roth account. Gains, losses and administrative expenses are to be charged on a reasonable basis between traditional accounts and Roth accounts [Reg. Section 1.401(k)-1(f)(2)].
2. An employee electing to designate salary deferrals as a Roth contribution is subject to the normal elective deferral limits. Thus, for 2006, an employee is able to electively defer $15,000 into a Roth account, plus an additional $5,000 catch-up contribution if the participant has attained age 50 by year-end. Contrary to traditional Roth funding, there is **no income limit** on elective deferrals into Roth accounts.

Observation

As a result of this change, higher income employees, who in the past have never been able to fund a Roth IRA because of the income phase-out eligibility rule, will now be able to move significant funds into a Roth account, if they so choose.

3. Any employer matching contributions must continue to be treated as pre-tax contributions and are subject to taxation when distributed to a participant at retirement.

4. Unlike the Roth IRA, a participant's Roth 401(k) account is only eligible for tax-free distribution after the account owner attains age 59½, dies, or becomes disabled, and also only after the Roth account has been in existence for more than five years after the year in which the individual first made a designated Roth contribution to that particular retirement plan or another elective deferral retirement plan. Further, a Roth elective deferral account is subject to the normal minimum required distribution rules that start at age 70½ [Reg. Section 1.401(k)-1(f)(3)]. However, this minimum required distribution rule can be avoided by simply rolling the Roth 401(k) account into a Roth IRA. A Roth IRA is not subject to minimum required distribution rules [Section 408A(c)(5)].

Observation

While the Roth elective deferral opportunity represents a significant change by allowing higher income employees to access Roth accounts, it places an additional administrative burden on the retirement plan. All Roth-designated accounts must be maintained separately, and earnings allocations to those Roth accounts must occur. On the other hand, the employer matching contribution remains in pre-tax status.

5.1.3 Sample amendment for Roth elective deferrals

The IRS has provided a sample amendment for plan sponsors and others who want to allow designated Roth elective deferrals in their Section 401(k) plans (IRS Notice 2006-44, IRB No. 2006-20).

5.2 Retirement Plan Provisions of 2001 Tax Act Made Permanent

The Pension Protection Act of 2006 repealed the sunset provision of the 2001 Tax Act that applied to pension and IRA matters, resulting in all pension provisions of the 2001 Tax Act becoming permanent (Act Sec. 811 of the Pension Protection Act of 2006).

The entire list of provisions made permanent is lengthy, with the detail provided in the Conference Committee Report to the legislation. Some of the more important provisions now made permanent are as follows:

- Increases in the IRA contribution limits, including the age 50 or over catch-up provision.
- Deemed IRAs under employer plans.
- Increases in the limits on contributions, benefits, and compensation under qualified retirement plans, tax-sheltered annuities, and eligible deferred compensation plans.

- Elective deferrals not taken into account for purposes of the deduction limits.
- Modifications to the deduction limits.
- Option to treat elective deferrals as Roth contributions.
- Credit for pension plan start-up costs.
- Catch-up contributions for individuals age 50 and over to 401(k), 403(b), 457, SARSEP, and SIMPLE plans.
- Faster vesting of employer matching contributions.
- Increased portability in rollovers of retirement plan and IRA distributions.

5.3 Defined Benefit Plans Allowed to Use Replacement Interest Rate

5.3.1 Background

While defined contribution plans provide for an individual account for each participant covered by the plan, defined benefit plans provide a definitely determinable benefit, and contributions to a defined benefit plan must be targeted to provide the promised benefits. Contributions are not based on profits, but rather on actuarially computed amounts, using an assumption that plan assets will grow at the same rate as the interest rate on a 30-year Treasury bond, which is no longer used.

Observation

The 30-year Treasury bond rate has been artificially low and is not realistic using current interest rates in the marketplace. Low interest rates result in projected future pension plan payouts to be understated and therefore require a higher current contribution amount.

Previously, the Pension Funding Equity Act of 2004 provided a temporary 2-year relief in 2004 and 2005 for pension plans impacted by low interest rates. This Act replaced the 30-year Treasury bond rate with a 4-year average of conservative long-term investment grade corporate bonds. Again, however, this temporary relief was only available for 2004 and 2005.

5.3.2 Replacement interest rate extended for two more years

The Pension Protection Act of 2006 has now extended this replacement interest rate calculation, as initially enacted by the Pension Funding

Equity Act of 2004, through plan years beginning prior to January 1, 2008.

5.4 Nonqualified Deferred Compensation Plans

5.4.1 Background

The use of deferred compensation arrangements to defer current taxation of income is widely used by many businesses. However, Congress was concerned that many nonqualified deferred compensation arrangements allowed improper deferral of income, often providing security of future payment and control by the employee over amounts deferred, but yet resulted in deferral of the recognition of the income.

5.4.2 Restrictions imposed on nonqualified deferred compensation plans

The American Jobs Creation Act of 2004 added Section 409A to provide comprehensive rules regarding the inclusion in gross income of deferred compensation under nonqualified deferred compensation plans. If at any time a nonqualified deferred compensation plan fails to meet any one of three requirements, the compensation plus related earnings must be included in taxable income of the employee, with the tax increased by a 20 percent penalty (calculated as 20 percent of the compensation!), and increased by interest (at the IRS underpayment rate plus 1 percent) on the underpayments that would have occurred had the deferred compensation been includable in income for the year in which first deferred. The three requirements that must continuously be met to avoid early taxation plus a penalty and interest are:

1. The distribution rule.
2. The election rule.
3. The acceleration of benefits rule (under which the plan may not permit the acceleration of the time or schedule of any payment, except as provided in regulations).

5.4.2.1 The distribution rule

The plan of deferred compensation must not permit distributions earlier than separation from service, the date the participant becomes disabled, death, a specified time or pursuant to a fixed schedule specified under the plan at the date of the deferral of the compensation, a change in the ownership or effective control of the employer, or the occurrence of an unforeseeable emergency.

Observation

These distribution rules, combined with the prohibition against any acceleration of benefits, will prevent an employee from electively accelerating the receipt of deferred compensation. It will also eliminate "haircut" provisions that allowed participants to receive early distributions at their election, subject to a minimal forfeiture or "haircut."

5.4.2.2 Election rule

The initial election to defer compensation must be made not later than the close of the preceding tax year. However, in the case of the first year in which the participant becomes eligible to participate in a deferred compensation plan, the election may be made with respect to services to be performed subsequent to the election within 30 days after attaining eligibility to participate in the plan. Also, performance-based compensation based on performance over a period of at least 12 months may be deferred via election no later than six months before the end of the period.

A change in the time and form of distribution may be made under a subsequent election, but only if the election may not take effect until at least 12 months after the date on which made. Also, unless the election relates to a distribution on account of death, disability or unforeseeable emergency, any deferral must be at least five years from the date on which such payment would otherwise have been made. If the deferred compensation is to be paid at a specific time or pursuant to a fixed schedule, any subsequent deferral election may not be made less than 12 months prior to the date of the first scheduled payment.

5.4.2.3 Definition of a nonqualified deferred compensation plan

A nonqualified deferred compensation plan is any plan that provides for the deferral of compensation other than a qualified employer plan and any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. Qualified employer plans excluded from these deferred compensation rules include Section 401 qualified pension and profit sharing plans, tax-deferred annuities, SEPs and SIMPLE plans.

Observation

The nonqualified deferred compensation rules do not apply to bonuses and other annual compensation amounts that are paid within 2½ months after the close of the tax year in which the services were performed. Also, the application of these rules is not limited to employees, but extends to deferral agreements with directors and other independent contractors.

5.4.2.4 Employer reporting requirements

If a nonqualified deferred compensation arrangement fails the criteria of Section 409A, the employer must include deferred compensation in income, reporting the amount on either Form W-2 or Form 1099. In addition, the total amount of deferrals for the year under a nonqualified deferred compensation plan must be reported on the Form W-2, even though not includable in income. Per IRS Notice 2005-1 (Q&A 27), a minimal amount of annual deferral of $600 or less does not require memorandum reporting.

5.4.2.5 Effective date and transition rules

The new nonqualified deferred compensation rules of Section 409A apply to any compensation deferred after December 31, 2004. Amounts earned and vested before January 1, 2005, are grandfathered. However, amounts deferred before January 1, 2005, are subject to the rules if a material modification is made to the nonqualified deferred compensation plan after October 3, 2004. The addition or acceleration of any benefit or feature is a material modification, but the reduction of a benefit, right, or feature is not considered a material modification.

Within 60 days of enactment of the legislation, the IRS was directed to provide guidance regarding amendment of plans to conform to the new rules, and a limited period during which existing plans may be amended to either terminate participation in the plan or to conform to the requirements of Section 409A with regard to amounts deferred after December 31, 2004. This Congressional mandate to provide guidance was subsequently satisfied with IRS Notice 2005-1 (IRS Notice 2005-1, IRB No. 2005-2).

IRS Notice 2005-1 allowed a remedial period **through December 31, 2005**, under which existing or new nonqualified deferred compensation plans could be amended in order to comply with the provisions of Section 409A. The plan must be operated in good faith compliance with the provisions of the statute and IRS Notice 2005-1 during calendar year 2005. This remedial period was extended in late September 2005 **through December 31, 2006** by IRS regulations.

Observation

The addition of Section 409A will require the review of virtually every nonqualified deferred compensation plan. While many plans will need to remove provisions that are not in compliance with Section 409A, other plans will benefit by conforming. An example would be the new ability to accelerate benefits in the event of an unforeseen emergency, which has not been contained in many existing deferred compensation agreements.

5.4.2.6 GOZA technical correction

Per a technical correction in the Gulf Opportunity Zone Act of 2005, the additional 20 percent penalty and interest are not treated as payments of regular tax for purposes of determining whether the AMT applies [Section 26(b) and Section 409A(a)(4)(C)(ii)].

5.5 Health Savings Accounts

5.5.1 Background

As part of the Medicare Prescription Drug Act of 2003, Congress enacted a replacement for the Medical Savings Account, known as the Health Savings Account or HSA (Section 223, P.L. 108-173, 12/8/2003). HSAs became available for tax years beginning after 2003.

Observation

The HSA is significantly more taxpayer friendly than the MSA. The HSA has a lower deductible on the high deductible health insurance policy, allows a greater percentage of the deductible to be funded (i.e., 100 percent rather than 65 percent or 75 percent) and allows individuals between ages 55 and 65 to make catch-up contributions to the HSA. Large employers, as well as small employers, can participate in an HSA, while MSAs only are available to smaller businesses. Finally, the HSA legislation is permanent, while MSAs were limited in number and duration.

5.5.2 Eligible individual

An eligible individual is one who is covered under a high deductible health insurance plan and, while covered under the high deductible plan, is not covered under any other non-high deductible health plan [Section 223(c)(1)]. However, an individual remains eligible for an HSA if he or she is covered under workers' compensation, insurance for a specified disease or illness, insurance paying a fixed amount per day, or insurance coverage for accidents, disability, dental care, vision, or long-term care.

An individual becomes ineligible for an HSA upon reaching age 65 and becoming enrolled to receive Medicare benefits [Section 223(b)(7)].

5.5.3 High deductible health plan

In the case of individual coverage, a high deductible health plan must have an annual deductible of at least $1,050, and the exposure to annual out-of-pocket expenses may not exceed $5,250 (2006 amounts). For

family coverage, there must be an annual deductible of at least $2,100 in total (per family, not per person), and annual out-of-pocket expenses may not exceed $10,500 (2006 amounts) [Section 223(c)(2)(A)].

5.5.4 Health savings account

The Health Savings Account or HSA is a trust established exclusively for the purpose of paying the qualified medical expenses of the account beneficiary. It must be governed by a written instrument, all investments must be in cash, and the trustee must be a bank, insurance company or other institution of the type that can sponsor an IRA. No part of the trust assets may be invested in life insurance. The trust may accept rollover contributions from an Archer MSA.

5.5.5 Maximum HSA contribution

The maximum for an individual coverage HSA that can be contributed annually is the smaller of the annual deductible or $2,700. With respect to an HSA involving family coverage, the annual contribution is the smaller of the annual deductible or $5,450 (2006 amounts, per IRS Notice 2005-70, IRB No. 2005-47). These annual HSA funding limits are converted to monthly amounts, because eligibility for funding hinges on participation in a high deductible health plan. For each month that an individual is an eligible participant in a high deductible health plan, they are entitled to contribute 1/12th of the HSA funding limit.

5.5.5.1 Age 55 catch-up contributions

If an individual has attained age 55 at the end of the tax year, the annual HSA contribution limit is increased by $700 for 2006. This catch-up limitation increases $100 annually, until reaching a total of $1,000 for 2009 and years following.

5.5.6 Employer contributions

Employers, as well as individuals, are permitted to contribute to HSAs, to the extent the employee is an eligible individual. If an employer makes a contribution to employee HSA accounts, comparable contributions must be made for the year for all comparably participating employees. Employer contributions are a tax-free benefit in the same manner as health insurance, and are also not subject to payroll taxes or income tax withholding.

5.5.7 Withdrawals from the HSA

Funds within the HSA grow free of income tax. The account beneficiary determines when withdrawals occur. Withdrawals taken to pay or reimburse out-of-pocket medical expenses are tax-free, but withdrawals not used for medical costs are taxable and subject to a 10 percent penalty.

Even though a HSA participant may not continue to fund an HSA after age 65 and enrolling in Medicare, the individual may continue to hold and accumulate HSA funds. An age 65 or older participant can also withdraw HSA funds tax free for use to pay health insurance premiums or Medicare Part B premiums, as well as other medical costs.

Upon death, a surviving spouse can succeed to an HSA account of the deceased spouse, assuming the surviving spouse was named as the successor beneficiary. To the extent a surviving spouse is not the successor beneficiary, the fair market value of the HSA must be includable in the income of the person or persons who inherit the account, reduced by any medical expenses of the decedent paid from the account within one year after death [Section 223(f)(8)].

5.5.8 IRS guidance

Following the enactment of Section 223, the IRS issued significant guidance to assist employers and individual taxpayers in establishing HSAs:

5.5.8.1 General guidance

Shortly after enactment of Section 223, the IRS issued Notice 2004-2, containing 38 questions and answers covering most aspects of HSAs (IRS Notice 2004-2, IRB No. 2004-2).

A more exhaustive summary of HSAs was provided later in 2004. In Notice 2004-50, the IRS issued an 88 question-and-answer release that covered additional information on eligibility, high deductible health plans, preventive care, contributions, distributions, comparability of employer funding, rollovers and other matters (IRS Notice 2004-50, IRB No. 2004-33).

5.5.8.2 Preventive care relief from high deductible rule

An HSA can only be established by an individual who is covered by a high deductible health plan. However, this high deductible requirement contains a significant exception for preventive care coverage. The IRS has provided guidance on the types of preventive care benefits, such as annual physicals, immunizations and screening services, which do not disqualify an individual from participation in an HSA (IRS Notice 2004-23, IRB No. 2004-15).

5.5.8.3 Interaction of HSAs with other health benefits

In general, an individual must have a high deductible health policy as the only coverage for traditional medical costs. However, the IRS has issued clarification of when limited participation in an employer-sponsored flexible spending account (Section 125 cafeteria plan) or

health reimbursement arrangement will not taint HSA eligibility. Employer reimbursement or salary reduction plans that restrict reimbursement to benefits such as vision, dental or preventive care services do not hinder HSA participation, nor do employer plans that only provide reimbursement after the minimum annual deductible has been satisfied (Rev. Rul. 2004-45, IRB No. 2004-22).

5.5.8.4 Additional IRS guidance issued

The IRS has issued a publication that provides a summary of HSA rules in a form that is suitable for business owners and clients. See IRS Publ. 969, *Health Savings Accounts and Other Tax-Favored Health Plans.* Also, at the U.S. Treasury website, the IRS has posted guidance in the form of "Frequently Asked Questions" regarding the establishment, use and administration of HSAs. See www.treasury.gov under Health Savings Accounts HSA.

The IRS has issued a ruling clarifying that an individual with a high deductible health insurance plan may contribute to an HSA, even if that individual's spouse has nonqualifying family coverage, provided that the spouse's nonqualifying coverage does not cover the individual. Further, an individual with an eligible high deductible health plan for any dependents not covered by a spouse's ineligible health plan may contribute to an HSA based on family coverage (Rev. Rul. 2005-25, IRB No. 2005-18).

Example. K Corp. provides a high deductible health for its employee, Ken, who has self-only coverage in this plan. Ken's spouse, Barb, has other ineligible health plan family coverage that covers Barb and their two children, but Ken is excluded from Barb's low deductible health plan coverage. Because Ken is not covered under Barb's health plan, he is an eligible individual for K Corp.'s HSA.

Example. Assume the same facts as in the preceding example, except that Ken enrolls in K Corp.'s high deductible health plan under family coverage for himself and one child. Again, Barb has ineligible low deductible health plan coverage for herself, and one other child is included in Barb's plan, but Ken is excluded from coverage in her plan. Because the ineligible health plan coverage of Barb does not cover Ken, Ken's HSA eligibility is not impacted.

The IRS has provided guidance on an S corporation's contributions to an HSA for the benefit of a more-than-2 percent S shareholder. Because of the Section 1372 rules treating a more-than-2 percent S shareholder as a partner for fringe benefit purposes, the contributions by the S corporation must be treated as wages of the S corporation, and are reportable as compensation income to the S shareholder. However,

because of the medical nature of the payment, the compensation is not subject to FICA. The S corporation shareholder, after reporting the additional wage income, is entitled to claim an offsetting pre-AGI deduction for the HSA funding that was reported as compensation (IRS Notice 2005-8, IRB No. 2005-4).

5.5.8.5 Final regulations on comparability rules for employer contributions

Final regulations have now been issued by the IRS, providing guidance on the comparability contribution rules that an employer must follow when the employer makes contributions to an employee's HSA (Regs. Sections 54.4980G-1 through 54.4980G-5, T.D. 9277, 7/28/2006).

5.6 Federal Per Diem Rates

The IRS has announced the new high-low per diem rates for 2006. These optional per diem allowances for lodging, and for business meals and incidental expenses incurred while away from home are based on a high-low method, with annual inflation adjustments.

The combined high rate for 2006 is $226 per day, consisting of $168 for lodging and $58 for meals and incidentals. The combined low rate for 2006 is $141 per day, consisting of $96 for lodging and $45 for meals and incidental expenses (Rev. Proc. 2005-67, IRB No. 2005-42).

Various limitations exist on the use of the high-low method, as follows:

- Self-employed taxpayers are not allowed to use the combined lodging and meal rates of $226 in a high-cost area and $141 in a low-cost area, nor are employees deducting their own expenses allowed to use these rates. The rates can only be used by employees or independent contractors who are under a reimbursement arrangement with a third party.
- Reimbursement by a related party (using a 10 percent ownership standard rather than the usual 50 percent standard of related-party definitions) cannot occur for either the combined per diem rates or the business meals and incidental expense rate.
- The high-low method may not be used separately for meals and incidental expenses only. Rather, per diem deductions for meals only are to be based on the federal employee travel rates applicable to the particular destination.

Observation
A special exception to the normal 50 percent meals disallowance exists for individuals subject to the hours of service limitations of the Department of Transportation. Such taxpayers are allowed a greater deductibility of meals expense, with only 25 percent disallowed for taxable years 2006 and 2007.

5.7 Debit or Credit Cards with FSAs and HRAs

The IRS has issued additional guidance allowing expanded use of debit or credit cards for employers making payments under health flexible spending accounts (FSAs) or health reimbursement arrangements (HRAs) (IRS Notice 2006-69, IRB No. 2006-31).

Observation
The expanded ability to treat reimbursements with debit or credit card payment and yet meet the required substantiation rules should reduce both the record keeping and time investment for employers and employees.

5.8 Medical Reimbursement Plans

5.8.1 Background

Proprietors are not able to deduct medical expense on Schedule C or Schedule F, although they are allowed pre-AGI deductibility under the 100 percent self-employed health insurance deduction. However, if a proprietor can legitimately establish an employer-employee relationship with his or her spouse, a business deduction for the health insurance premiums and also potentially for medical reimbursements under a Section 105 medical reimbursement plan or a health reimbursement arrangement can be obtained (Rev. Rul. 71-588, 1971-2, CB 91; PLR 9409006).

5.8.2 Medical reimbursement plan approved for employee-spouse

The Tax Court approved a medical reimbursement arrangement between the employer-spouse who operated a licensed day care business and her employee-husband (*Speltz v. Comm.*, TC Summary Opinion 2006-25, 2/14/2006).

The husband was employed on a part-time basis, working a minimum of 12.5 hours per week and a minimum of seven months per year.

The husband was paid compensation of $542 per month or $6,500 per year, but the entire compensation was paid to the employee-husband in the form of medical reimbursement plan amounts. No other wages were paid to the husband other than the fringe benefit amounts for the medical reimbursement plan, which were deducted by the employer-wife on her Schedule C and treated as a tax-free fringe benefit by the employee-husband.

The court determined that a legitimate employer-employee relationship existed, even though the husband had full-time employment elsewhere. The medical reimbursement plan was well documented and the husband met all aspects of his employment agreement. The court found the fact that the employee-spouse received his entire compensation in the form of a tax-free fringe benefit did not present a problem, given the substantiated employment contract between the two spouses and the substantiated and well-documented medical reimbursement plan.

5.9 Accountable Plans

5.9.1 Background

Businesses are allowed to either reimburse employees for actual travel and entertainment expenses incurred or implement a per diem or other expense allowance arrangements with employees. Tax treatment of such arrangements depends upon whether the arrangement is an accountable plan.

To be an accountable plan, three requirements must be met:

- Employees must be reimbursed for business expenses that would be deductible if paid directly by the employer.
- Employees must provide substantiation to the employer of the business nature of each expense and if applicable, additional documentation required for travel and entertainment items.
- Employees are required to return any portion of the advance paid to them in excess of actual expenses substantiated by the employee.

5.9.2 Company fails accountable plan requirements

In an appellate court affirmation of a Tax Court decision, accountable plan treatment was not allowed regarding reimbursements made to employees, resulting in the reimbursements being required to be included in employee compensation (*Namyst v. Comm.*, CA-8, 1/27/2006, aff'g. TC Memo 2004-263). The employer had established an arrangement with employees to reimburse employees for various

business expenses, including tool purchases, but when the reimbursements were made to the employees, the recipients received excess payments which were not required to be returned to the employer and the reimbursements did not correlate to the actual expenses.

The employer argued in court that the substantiated amounts should qualify under the accountable plan rules, with only the excess payments becoming taxable to the recipients. The court determined that if it allowed this approach it would effectively eliminate the third test of the accountable plan rules. Accordingly, all payments under the arrangement needed to be included in the recipients' income.

6. OTHER MAJOR DEVELOPMENTS

6.1 Deduction for Domestic Production Activities

6.1.1 Background

Prior to 2005, the Code provided no provision to reduce taxable income attributable to U.S. production activities. However, to offset the repeal of the extraterritorial income (ETI) exclusion of Section 114, Congress enacted a new deduction to benefit businesses with U.S. production activity net income. Even though the repeal of the Section 114 exclusion is phased out gradually over three years (100 percent retained for transactions in 2004, 80 percent applicable to transactions in 2005, and 60 percent applicable to transactions in 2006, before total repeal in 2007), Congress added the new production deduction (Section 199) immediately for tax years beginning in 2005.

6.1.2 Calculation of production deduction

For tax years beginning in 2005, the production deduction is calculated as 3 percent of the smaller of:

1. Taxable income determined without regard to this provision (or modified AGI in the case of an individual), or
2. The qualified production activities income of the taxpayer for the year [Section 199(a)].

The production deduction percentage phases in in three increments, as follows:

Tax Year Beginning In	*Deduction Percentage*
2005 or 2006	3 percent
2007, 2008, or 2009	6 percent
2010 and following	9 percent

6.1.3 Eligible production income

Qualified production activities income is defined as the taxpayer's domestic production gross receipts for the year reduced by the sum of the cost of goods sold allocable to such receipts, other deductions, expenses or losses directly allocable to such receipts, and a ratable portion of other deductions and expenses not directly allocable to such receipts or any other class of income.

Observation
Effectively, this computation requires the calculation of net income, including an allocation of indirect expenses, attributable to the qualifying production gross receipts.

The following production activities conducted in the U.S. qualify for the new production deduction:

- Construction, including engineering or architectural services for construction projects in the U.S.
- Any lease, rental, license, sale, exchange or other disposition of tangible personal property, computer software, and sound recordings that were manufactured, produced, grown or extracted in whole or in significant part by the taxpayer within the U.S.
- Qualified film production, and electricity, natural gas, or potable water production in the U.S. [Section 199(c)(4)].

However, the term does not include gross receipts derived from the sale of food and beverages prepared by a taxpayer at a retail establishment, and the transmission or distribution of electricity, natural gas, or potable water.

Observation
Manufacturers, ag producers, and construction businesses generally will qualify, while retail and wholesale distributors and service activities will not qualify.

6.1.4 The wage limitation

The amount of the deduction for a tax year may not exceed 50 percent of the W-2 wages of the employer for the year [Section 199(b)(1)].

Law Change Alert
Based on a change in the Tax Increase Prevention and Reconciliation Act, the 50 percent wage limit is applied by considering only wages properly allocable to domestic production gross receipts, effective for tax years beginning after May 17, 2006 [Section 199(b)(2)(B)].

In guidance issued early in 2005, the IRS provided three alternatives for calculating the wage limit for the production deduction (IRS Notice 2005-14, IRB No. 2005-7). In issuing final regulations, rather than placing the rules regarding the wage limitation in the regulations themselves, the IRS moved the specific rules on determining the wage limitation to a revenue procedure, which describes the same methods as were described in IRS Notice 2005-14. In this manner, the IRS noted that if changes are made to the Form W-2 that impact the calculation of the wage limitation, it will be easier to issue a new revenue procedure than to amend the regulations. The guidance on the wage limitation is contained in Rev. Proc. 2006-22 (IRB No. 2006-22). The three alternative methods for calculating Form W-2 wages are:

6.1.4.1 Unmodified box 1 method

This is the lesser of the total entries in box 1 of all Forms W-2 issued by the employer, or the total entries in box 5 of all Forms W-2 filed by the taxpayer.

6.1.4.2 Modified box 1 method

This method takes the total box 1 Form W-2 amounts and subtracts amounts not subject to federal withholding under Section 3401, and also subtracts items treated as wages under Section 3402(o) (i.e., supplemental unemployment compensation benefits), and then adds elective deferrals reported in box 12 of Form W-2 with codes D, E, F, G and S.

6.1.4.3 Tracking wages method

This method calculates the actual wages subject to income tax withholding, subtracts the supplemental unemployment compensation benefits included in the total, and adds specific elective deferrals reported in box 12 of Forms W-2 with Codes D, E, F, G and S.

Observation

Effectively, these methods all require the calculation of wages that are subject to either FICA or federal income tax withholding.

6.1.5 IRS guidance

Initial guidance on Section 199 was issued by the IRS in Notice 2005-14 (IRB No. 2005-7). Then, in October of 2005, proposed regulations were issued by the IRS (Prop. Regs. Sections 1.199-1 through 1.199-8, REG-105847-05, 10/20/2005). In May of 2006, final regulations were issued by the IRS (Regs. Sections 1.199-0 through 1.199-9, T.D. 9263).

Observation

The final regulations apply to tax years beginning on and after June 1, 2006. The proposed regulations govern for prior tax years, such as 2005

and 2006. Taxpayers are allowed to apply the final regulations, rather than the proposed regulations, to periods beginning prior to June 1, 2006. However, if a taxpayer applies the final regulations to these prior periods, they must be applied in their entirety.

6.1.6 Identifying U.S. production

In general, distributors are ineligible for the new U.S. production deduction. Packaging, labeling, and minor assembly of foreign-produced goods are nonqualified items. However, IRS guidance contains a safe harbor, indicating that the taxpayer will be considered to have achieved manufacturing or qualified production status if there is "significant U.S. production." The safe harbor indicates that significant U.S. production occurs if direct labor and related burden of the taxpayer within the U.S. equals or exceeds 20 percent of the total cost of the property.

> *Example.* James Corp. is a business that imports partially finished leather goods, and adds decorative accessories, functional enhancements and embossed labels to these goods before selling the leather products. Tested on a product by product basis, James Corp. will be considered a manufacturer for those goods in which its direct and indirect costs equal or exceed 20 percent of the total cost of the property. If James Corp. finds that some of its product lines involve qualifying production because the James Corp. costs equal or exceed 20 percent of the total cost of the property, but other products do not achieve this threshold, the net income attributable to ineligible products cannot be counted in the production deduction computation.

6.1.7 Segregating ineligible net income

Taxpayers with both qualifying and nonqualifying activities are required to determine the net income from the qualified activities to calculate the production deduction. Three methods are provided for allocating costs:

1. Apportion costs according to the Section 861 regulations.
2. Use a simplified method applicable to business with under $100 million of gross receipts ($25 million if the proposed regulations are used), allowing pro-rata allocation of overhead based on gross receipts, with modifications.
3. Use a simplified small taxpayer method for those with under $5 million of gross receipts, or those with under $10 million of gross receipts using the cash method under the authority of Rev. Proc. 2002-28. These taxpayers are allowed to use a simplified pro-rata allocation of expenses based on gross receipts.

In addition, there is an important de minimis exception, providing that nonqualifying activities are ignored if total nonqualified gross receipts are under 5 percent of all gross receipts.

Example. Assume that James Corp. in the preceding example has only several products in which its costs do not achieve the 20 percent safe harbor. Further, assume that the gross receipts attributable to those nonqualifying products represent under 5 percent of all gross receipts of the corporation. In this case, based on the de minimis exception, James Corp. could ignore the nonqualifying gross receipts and treat all net income as eligible for calculation of the production deduction.

6.1.8 Overcoming the 50 percent wage limit

Some small corporations, particularly S corporations, lack sufficient wages to utilize their full production deduction because of the limitation of 50 percent of wages that serves as a cap for the new production deduction.

Observation

Businesses should test the production deduction computation prior to year-end, and determine if the deduction is limited by the 50 percent of wages computation. If so, those businesses should consider increased compensation prior to year-end, to allow full deductibility of the production deduction.

6.1.9 Pass-through entities

Under a technical correction enacted by the Gulf Opportunity Zone Act of 2005, items arising from the taxable year of a pass-through entity beginning before 2005 are not taken into account for purposes of calculating the deduction or wage limitation at the Form 1040 level.

Also, the final regulations make it clear that the Section 199 deduction has no effect on a shareholder's adjusted basis in the stock of an S corporation or a partner's adjusted basis in an interest in a partnership [Regs. Sections 1.199-9(e)(1)(i) and 1.199-9(c)(1)(i)].

The Tax Increase Prevention and Reconciliation Act eliminated the limitation of a partner's or shareholder's pass-through wage amount to twice the pass-through production deduction, effective for taxable years beginning after May 17, 2006. Accordingly, for taxable years beginning after this date, the wages of a business pass through to the Form 1040 for Section 199 purposes without the limitation of double the production deduction [Section 199(d)(1)(A)(iii)].

6.2 Estimate Payment Amounts for Large Corporations

6.2.1 Background

Corporations are generally required to make quarterly estimated tax payments of their income tax liability, with calendar year corporations required to make such estimate payments by April 15, June 15, September 15, and December 15 of each year.

6.2.2 Modification of estimate payment amounts for large corporations

The Tax Increase Prevention and Reconciliation Act requires corporations with assets of at least $1 billion as of the end of the preceding year to make estimated payments as follows:

- For any estimate payments due in July, August and September, 2006, 105 percent of the payment amount otherwise due was required to be paid, with a reduction of the additional amount in the next required payment.
- For payments due in July, August and September, 2012, 106.25 percent of the payment otherwise due is required to be paid, with a reduction of the additional amount in the next required payment.
- For payments due in July, August and September, 2013, 100.75 percent of the payment otherwise due is required to be paid, with a reduction of the additional amount in the next required payment.

For any corporation, despite its size, with an estimated tax payment due on September 15, 2010, 20.5 percent of the amount otherwise due need not be paid until October 1, 2010. Similarly, for any corporation, despite its size, with an estimated tax payment due on September 15, 2011, 27.5 percent of the amount otherwise due need not be paid until October 1, 2011.

6.3 Reasonable compensation in C corporations

6.3.1 Background

The reasonableness of compensation is a question of fact. Case law has provided an extensive list of factors that are relevant in determining the reasonableness of compensation (*Comtec Systems, Inc. v. Comm.*, TC Memo 1995-4; *Acme Construction Co., Inc. v. Comm.*, TC Memo 1995-6). Twelve factors have frequently been used by the Tax Court:

1. The employee's qualifications.
2. The nature, extent and scope of the employee's work.
3. The size and complexity of the business.
4. A comparison of salaries paid with sales and net income.
5. General economic conditions.
6. Comparison of salaries to distributions to shareholders and retained earnings.
7. The employer's salary policy to all employees.
8. The employer's financial condition.
9. The going rates of compensation for comparable positions in comparable companies.
10. Compensation paid in prior years.
11. Whether the employee and employer dealt at arms-length.
12. Whether the employee guaranteed the employer's debt.

Several Appeals Courts have used a five-factor test to measure the reasonableness of compensation:

1. The employee's role in the company.
2. A comparison of compensation paid to similarly situated employees in similar companies.
3. The character and condition of the company.
4. Whether a conflict of interest exists that might permit a company to disguise dividend payments as deductible compensation.
5. Whether the compensation was paid pursuant to a structured, formal and consistently applied program [*Elliotts, Inc.*, CA-9, 1983].

6.3.2 Independent investor test used to arrive at reasonable compensation amount

The Tax Court applied the independent investor test in establishing the reasonable compensation amount for the president-owner of a family corporation (*Wechsler & Co., Inc.*, TC Memo 2006-173). The court also adjusted compensation amounts made to other family members. While the court focused on the significant contributions made to the success of the business by the corporate president, it also looked to the independent investor test, asking the question of what an independent investor would expect as a reasonable return on his or her investment. The government expert testified at trial that approximately $9 million out of a total of approximately $38 million paid to the president-owner was reasonable, but this was rejected by the court, which found that this would undercompensate the individual for the successful role he had played in building the company.

After completing a detailed analysis based on the independent investor test, the court allowed $16 million as representing a reasonable

compensation amount to the president-owner over the period in question, noting that even after the salary amount, a 16.3 percent compound annual return on equity resulted, which the court felt "an independent investor would be satisfied with."

Additionally, the compensation of the president's wife was reduced by approximately one-half of the amount originally paid to her and salary amounts paid to a brother of the president of approximately $200,000 were totally disallowed by the court, which determined that there was no proof that the brother actually performed any services for the corporation whatsoever.

6.4 Personal Service Corporations

6.4.1 Background

A qualified personal service corporation (PSC) is taxed at a flat corporate rate of 35 percent under Section 11(b)(2). For purposes of this flat 35 percent tax rate, a PSC is defined under both a services test and an ownership test, as follows:

- Substantially all of the activities of the corporation must involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting.
- Substantially all of the stock of the corporation, by value, must be held by employees performing services for the corporation.

As it relates to the first test for services, substantially all of the activities of the PSC are considered in professional service fields if 95 percent or more of the time spent by the employees of the corporation is devoted to the performance of services in one of the eight listed fields. Regarding the second test related to ownership, substantially all of the corporation's stock is defined as an amount equal to or greater than 95 percent of the stock.

6.4.2 PSC status voided

A CPA operated his accounting practice as a C corporation, but over the years, the corporation developed a secondary business of providing investment services for clients. The taxpayer eventually split the operation into two separate businesses, with the C corporation continuing to conduct the accounting and tax preparation services, and with a new limited liability company performing the financial and investment services. Both entities were solely owned by the same taxpayer.

The businesses shared office space and operated with the same employees, but the owner allocated the time of the employees to each operation and also allocated other expenses. The IRS argued that the accounting corporation was a PSC, because it was owned totally by the taxpayer performing accounting services and all of its revenue related to professional services. As such, the flat 35 percent corporate tax rate was applied.

However, the Tax Court found that all employees, including those of the limited liability company, were common law employees of the accounting corporation. Finding that only about 80 percent of the employees' time was devoted to accounting and the other 20 percent was devoted to financial services, the court ruled the corporation was not a PSC because brokerage commissions were earned, rather than revenue primarily from professional services (*Lykins, Inc.*, TC Memo 2006-35).

Observation

If the salaries of the employees for the investment services entity had not been allocated to the accounting corporation, the accounting corporation would have been subject to the flat 35 percent tax rate as a PSC. Separately, however, the National Association of Securities Dealers has regulations governing licensed brokerage activities which require the segregation of brokerage activities from other professional services.

6.5 Treatment of Distributions from Closely-Held Corporations

The Tax Court ruled that distributions made by a closely-held corporation to a majority shareholder represented loans rather than constructive dividends (*Teymourian*, TC Memo 2005-232). The court analyzed the following seven factors in reaching its decision

- Written note: A written loan agreement or note was never executed between the taxpayer and corporation. IRS favored.
- Interest charged: Taxpayer had paid $50,000 to the corporation on the prior disbursement. Taxpayer favored.
- Repayment schedule: A repayment schedule did not exist between the taxpayer and the corporation. IRS favored.
- Collateral: Security agreement collateralizing loan with shares in corporation was never signed. IRS favored.
- Repayment of disbursement: $400,000 was repaid by the taxpayer on a total disbursement of approximately $1.5 million. Taxpayer favored.

- Prospect of repayment: Taxpayer was financially able to repay advance and in fact had repaid a substantial portion. Taxpayer favored.
- Conduct of the parties: Both the taxpayer and another shareholder testified that the disbursements were intended to be loans and the corporation treated the disbursements as loans on its books. Taxpayer favored.

Although the factors did not weigh heavily in either direction, the court found that the scale tipped in favor of the taxpayer and that the disbursements qualified as legitimate loans.

6.6 2006 Blended Applicable Federal Rate

The IRS has announced that the blended annual rate for 2006, representing the minimum required interest rate on demand loans during the year which applies to amounts that are outstanding for the entire year, is 4.71 percent (Rev. Rul. 2005-38, IRB No. 2005-27).

Observation
The 2006 blended rate of 4.71 percent compares to 3.11 percent in 2005, 1.98 percent in 2004, and 1.52 percent in 2003.

6.7 Shareholder Advances to Corporation Treated as Equity

The Tax Court originally held that cash advances made to a corporation by controlling shareholders represented equity or capital infusions rather than debt, and accordingly the corporation was denied interest expense deductions. The court reviewed a number of criteria, noting that the loans were unsecured and initially unwritten, interest was paid at an above-market rate, and repayments were sporadic based on the shareholders' financial needs rather than predetermined debt due dates (*Indmar Products Co., Inc. v. Comm.*, TC Memo 2005-32, 2/23/2005).

However, upon appeal, the Sixth Circuit reversed the lower court and held that the shareholder advances to the corporation represented loans and not equity, thereby allowing the deductibility of interest paid on the amounts (*Inmar Products Co., Inc. v. Comm.*, CA-6, 4/14/2006, rev'g. TC Memo 2005-32). The higher court found a number of errors in the lower court opinion and analyzed eleven factors differentiating debt from equity. The appellate court found that eight of the eleven factors favored debt, and although two of the three remaining factors favored equity, the factors were less important than several of the factors which favored debt. In fact, the court noted that only one factor of any

significance favored equity, which was far outweighed by the eight factors favoring debt.

6.8 Like-kind Exchanges

6.8.1 Background

Some voluntary exchanges are nontaxable. Property received is treated as a continuation of the old investment. Gain or loss is not recognized until a disposition of the property received in the exchange. To be nontaxable, such a like-kind exchange must meet *all* of the following conditions:

1. The property must be business or investment property [Section 1031(a)(1)].
2. The property must not be property held for sale.

Note

Inventories, raw materials, accounts receivable, other current assets, and real estate that dealers hold for sale to customers are examples of property that do not qualify.

3. The property must be an exchange of "like-kind" property.

Note

The IRS takes the position that in determining whether an exchange of one asset for another is a like-kind exchange, it will look at the nature of the underlying property rather than only at the nature of the business involved.

4. The property must be tangible property.

Note

Nontaxable exchanges do not apply to exchanges of stocks, bonds or other securities.

5. If not simultaneous, the exchange must meet an identification requirement and a completed transaction requirement.

6.8.2 Related party exchanges

A Section 1031 exchange is permitted between related parties. However, if property is received in a like-kind exchange between related persons under Section 267(b) or Section 707(b)(1) [which includes two corporations that are members of the same controlled group or an individual and a more than 50 percent (in value) owned corporation], and the property is disposed of before a date that is less than two years after

the date of the last transfer in the exchange, the gain or loss that was not recognized on the original exchange is recognized as of the date of disposition [Section1031(f)].

Under this two-year rule, exceptions exist for a disposition within the two-year period (1) after the earlier of the death of the taxpayer or the related person, (2) in a compulsory or involuntary conversion (under Section 1033) if the exchange occurred before the threat or imminence of such conversion, or (3) where neither the exchange nor disposition had as one of its principal purposes the avoidance of tax. Also, the running of the two-year period is suspended where there is substantial diminution of risk [Section 1031(g)].

The IRS has issued a ruling indicating that a taxpayer who transfers property to a qualified intermediary in a Section 1031 exchange for replacement property that was formerly owned by a related party does not meet the nonrecognition rules (Rev. Rul. 2002-83, 2002-2 CB 927). The IRS views this as violating the related party exchange rule, noting that Section 1031(f)(4) provides that the like-kind exchange rules do not apply to any exchange that is part of the transaction or series of transactions structured to avoid the related party prohibition.

Example. Black, Inc., a corporation 100 percent owned by Pete and his spouse, owns land with a low basis and market value of $800,000. A developer approaches the corporation, offering to pay cash for this property.

To accomplish the sale, Black enters into an agreement with a qualified intermediary, transferring this land to that intermediary under an exchange agreement. The intermediary subsequently transfers Black, Inc.'s land to the developer in exchange for $800,000. One week later, the intermediary purchases land owned by Pete for $800,000 that has an adjusted tax basis to Pete of $750,000. The intermediary uses this real estate to complete the exchange with Black, Inc. Under Rev. Rul. 2002-83, this transaction does not qualify for exchange treatment because Pete and Black, Inc. are related parties. Black, Inc. must report a taxable sale.

Observation

In its analysis in Rev. Rul. 2002-83, the IRS noted that the affect of using an intermediary in the preceding example is the same as if Black, Inc. had first exchanged its land with Pete, and then Pete had sold the property to the developer at a nominal gain. The series of transactions accomplished by Black, Inc. with the intermediary in the preceding example would have allowed a related party (Pete) to receive the cash without significant gain recognition, if the related party rule were not imposed by the IRS.

The Tax Court has taken a position similar to Rev. Rul. 2002-83, holding that a corporation could not defer gain under Section 1031 by structuring the transaction through a qualified intermediary, where

the qualified intermediary used the sale proceeds from the relinquished property to invest in replacement property owned by a related corporation. In the court's view, the qualifying intermediary was used in an attempt to circumvent the related party prohibition to Section 1031 like-kind exchanges (*Teruya Brothers, Ltd. and Subsidiaries v. Comm.*, 124 TC No. 4, 2/9/2005).

6.8.3 Related party exchange using a qualified intermediary approved

In a private ruling, the IRS has approved a series of exchanges between related parties with the help of a qualified intermediary for purposes of like-kind exchange treatment (PLR 200616005). A trust transferred property 1 to a buyer and the trust subsequently acquired property 2, owned by a related-party S corporation. The S corporation also exchanged property 2 for other like-kind property.

The trust and the S corporation wished to facilitate the exchange through the use of a qualified intermediary, who would be treated as the seller of property 1 to the buyer and the acquirer of property 2 from the S corporation. The qualified intermediary would subsequently transfer property to the trust in exchange for property 1. At that point, the qualified intermediary would acquire additional replacement property and transfer that property in exchange for property 2 to the S corporation.

The IRS approved the transaction, distinguishing the private ruling from its previous guidance in Rev. Rul. 2002-83, finding that the prior ruling had tax avoidance as one of its objectives. Under the facts of the private ruling, the IRS determined that no tax avoidance motive existed, as long as neither party disposed of the exchanged property within a two-year period. Through the use of the qualified intermediary, the IRS determined the transaction was not between related parties and accordingly like-kind treatment was approved.

6.8.4 Like-kind exchange treatment not allowed for trademarks and tradenames

Consistent with previous rulings and regulatory guidance, the IRS did not approve like-kind exchange treatment for the exchange of patents, trademarks, and other intangible property (TAM 200602034). Because no asset classes are provided for intangible properties, the exchange of intangible property requires the matching of the nature or character of the rights involved and the nature or character of the underlying property to which the intangible personal property relates.

The IRS determined that the nature or character of the rights involved was of a like-kind nature, but did not find matching of the

nature or character of the underlying property to which the intangible property relates.

Observation
Previous IRS guidance makes it clear that the exchange of goodwill and going concern value of one company for the goodwill and going concerning value of a second company is not like-kind [Reg. Section 1.1031(a)-2(c)(2)].

6.8.5 Like-kind or class requirements

In a private ruling, the IRS has indicated that a passenger car and a sport utility vehicle (a light truck) are like-kind property for Section 1031 exchange purposes, even though the assets are in different general asset classes under Rev. Proc. 87-56. The IRS noted that SUVs and passenger cars are like-kind property, with the differences representing grade or quality distinctions and not differences in nature or character. The rule allowing Section 1031 like-kind treatment for assets in the same cost recovery general asset class represents a safe harbor, and is not the only manner for determining like-kind status (PLR 200450005, 12/15/2004).

The IRS has issued final regulations replacing the use of the Standard Industrial Classification (SIC) system with the North American Industry Classification System (NAICS) for determining when tangible personalty is within the same product class for purposes of the like-kind exchange rules of Section 1031. Under these regulations, depreciable tangible personal property is considered like-kind in an exchange if it is described in the same six-digit product class within Sectors 31, 32, and 33 of the NAICS codes. These regulations apply to transfers of property on or after August 12, 2004 [Reg. Section 1.1031(a)-2(b)(3), T.D. 9202, 5/19/2005].

Example. Ace Construction, Inc. trades a grader to a vendor in exchange for a new scraper. Neither property is within the general asset classes affecting property such as computers or automobiles. However, both properties are within the same product class, NAICS code 333120. The grader and scraper are of a like product class and are treated as like-kind exchange property for purposes of Section 1031.

6.9 Corporate Tax Payments, Credits, and Compliance Matters

6.9.1 Disabled access credit

The Tax Court has held that an individual could not claim the disabled access credit for the purchase price of two pay telephones. The expenditure had no relationship to the requirement of allowing a small business

to comply with the Americans with Disabilities Act. Further, the "investment" in the telephones lacked the benefits and burdens of ownership, and the taxpayer was also denied depreciation deductions (*Edward R. Arevalo v. Comm.*, 124 TC No. 15, 5/18/2005).

Observation

The IRS has included Section 44 disabled access credit schemes in a list of potentially abusive tax shelter or tax scam arrangements. According to the IRS, promoters claim that by purchasing equipment and services for an inflated price, a taxpayer can claim the disabled access credit to reduce tax or generate a refund. However, the IRS notes that in these schemes, taxpayers participating typically are not required to pay and do not pay the entire price stated in the sales contract (IRS Notice 2005-30, IRB No. 2005-14).

In two separate Tax Court decisions, the court ruled that amounts paid for a subscription to a program which allowed a hearing-impaired individual to communicate via computer with another individual over the telephone did not qualify for the disabled access credit (*Svoboda v. Comm.*, TC Memo 2006-1, 1/3/2006; *Galyen v. Comm.*, TC Memo 2006-30, 2/22/2006).

While the computer program represented an alternative to the Telecommunication Relay Service, the court found the computer program did not comply with the Americans with Disabilities Act, because the taxpayers were already in compliance with the Americans with Disabilities Act through the use of the Telecommunication Relay Service.

6.9.2 Home contractor energy credit

6.9.2.1 Background

The 2005 Energy Act created a new business credit for home contractors that construct and sell a dwelling that is acquired by a person from the contractor for use as a residence (Section 45L).

Key points regarding this new tax credit include the following:

- The credit applies to homes whose construction is substantially completed after August 8, 2005, and which are purchased from the contractor after December 31, 2005, and before 2008.
- The home must be acquired from the contractor for use as a residence, but there is no requirement in the statute that the residential use be as the purchaser's principal residence. This suggests that use as a seasonal or vacation dwelling qualifies.
- The credit is available to the contractor for the construction of a qualified new energy efficient home. The home must be located in

the U.S., and can be a property that was substantially reconstructed and rehabilitated.

- The credit is calculated per dwelling unit. The credit is $2,000 per dwelling unit if the property has an annual heating and cooling energy consumption which is at least 50 percent below the annual level of the heating and cooling energy consumption of a comparable dwelling unit based on technical standards to be further refined and issued by the IRS. The credit is $1,000 per dwelling unit in the case of a manufactured home that meets a threshold of at least 30 percent reduction in energy consumption.
- As a business credit, the new energy efficient home credit reduces regular tax, but does not reduce AMT.
- The basis of the residence must be reduced by the energy credit allowed.
- As part of the general business credit system, the home contractor energy credit is eligible for carryback and carryover if it is in excess of the current year tax liability. However, no credit is available to be carried back to any tax year ending on or before the effective date of the energy efficient home credit.

6.9.2.2 Guidance issued on claiming of credit

The IRS has now released two items of guidance, one pertaining to manufactured homes and the other to all other homes on how an eligible contractor can obtain certification that a dwelling unit qualifies for the new credit (IRS Notices 2006-27 and 2006-28, IRB No. 2006-11). The guidance also contains a list of public software programs used to calculate the energy consumption for purposes of obtaining certification.

The required certification must be obtained by a contractor from an individual eligible to issue the certification prior to claiming the credit for a dwelling unit. Contractors are not required to attach the certification to the tax return when the credit is claimed, but the certification must be retained with the books and records of the contractor. The guidance details the qualifications of an individual allowed to issue the certification and also provides a rather lengthy list of the information to be included in the certification.

6.9.3 Alternative motor vehicle credit

As part of the 2005 Energy Act, Congress added an alternative motor vehicle credit that applies to four types of new vehicles:

- Qualified fuel cell motor vehicle.

- Advanced lean burn technology motor vehicle.
- Qualified hybrid motor vehicle.
- Qualified alternative fuel motor vehicle (Section 30B).

The following points are applicable to all versions of this credit:

- The credit is treated as part of the general business credit system for business taxpayers, and is treated as a personal tax credit for individual taxpayers acquiring a vehicle in a nonbusiness or nondepreciable context. However, to the extent of any business use, the credit is not permitted to the extent the deduction is claimed under Section 179 for the vehicle, nor may any double benefit be claimed for both business usage and eligibility for the credit.
- The vehicle must be new rather than used.
- The credits are available for vehicles placed in service after 2005. The various credits expire for years ranging from 2010 to 2015, depending on the particular category of vehicle.
- In the case of a vehicle purchased (but not leased) by a governmental or tax-exempt entity, the person who sold such vehicle to the exempt entity is treated as the taxpayer that placed the vehicle in service, and is entitled to the credit.

6.9.3.1 Qualified fuel cell motor vehicle

A credit of $8,000 is allowed for any qualified fuel cell motor vehicle with a gross vehicle weight rating of not more than 8,500 pounds. This credit escalates to greater amounts for heavier vehicles. In addition, there is an enhancement to the credit ranging from $1,000 to $4,000, based on the increased fuel efficiency of the vehicle compared to 2002 city fuel economy standards. A fuel cell vehicle is one propelled by power from one or more cells that convert chemical energy directly into electricity by combining oxygen with hydrogen fuel that is stored onboard the vehicle [Section 30B(b)].

6.9.3.2 Advanced lean burn vehicle credit

This version of the Section 30B vehicle credit applies to a passenger auto or light truck with an internal combustion engine that is designed to operate primarily using more air than necessary for complete combustion of the fuel, incorporating direct injection, and achieving at least 125 percent of increased fuel efficiency compared to 2002 model year city fuel economy standards. The credit increases incrementally as the percentage of fuel economy increases, with the credit ranging from $400 to $2,400. In addition, there is a conservation credit that ranges

from $250 to $1,000 based on the lifetime fuel savings that the vehicle is anticipated to realize.

6.9.3.3 Hybrid vehicle credit

A hybrid vehicle credit is allowed for vehicles that draw propulsion from both an internal combustion engine and a rechargeable energy storage system or heat engine.

Observation

Previously, hybrid vehicles, categorized as "clean fuel vehicles," resulted in a $2,000 deduction. This deduction was repealed for hybrid vehicles placed in service after 2005, and replaced by the alternative vehicle credit.

The qualified hybrid vehicle receives a credit using the same sliding scale that applied to the advanced lean burn vehicles. Accordingly, this credit will range from $400 to $2,400, based on the fuel economy, and an initial conservation credit from $250 to $1,000 also would be available, based on the projected gallons of fuel saved over the useful life of the vehicle.

6.9.3.4 Alternative fuel vehicle credit

This credit applies to vehicles that burn only natural gas, LP, hydrogen, or 85 percent methanol. The credit allowed is based on a percentage of the incremental cost of the energy efficient components of the vehicle. The credit is 50 percent of the incremental cost of the energy enhancement, plus 30 percent if the vehicle receives clean air certification and meets or exceeds specified clean air standards.

A reduced credit for alternative fuel vehicles is provided for "mixed fuel vehicles." These are vehicles that burn both alternative fuels and conventional petroleum-based fuels.

6.9.3.5 Guidance issued by IRS on alternative motor vehicle credit

The IRS has released initial guidance on the alternative motor vehicle credit, providing clarification on the manner in which a manufacturer can property certify a vehicle (IRS Notice 2006-9, IRB No. 2006-6).

6.9.4 Low-income housing credit certification

The IRS has announced that it plans to allow taxpayers claiming the low-income housing credit to file IRS Form 8609, *Low-Income Housing Credit Allocation and Certification,* only once instead of requiring the form to be filed for fifteen consecutive years (Preamble to Reg. Section 1.42-1, T.D. 9228, 11/4/2005).

Observation

Under previous rules, a completed Form 8609 was required to be filed for each of the fifteen years of the low-income housing credit compliance period. Additionally, owners of qualified low-income property must currently attach Form 8586, *Low-Income Housing Credit,* to the tax return for each year the owner is claiming the credit.

6.9.5 Credit for fuel from a nonconventional source

Under a change enacted by the Gulf Opportunity Zone Act of 2005, the credit for producing fuel from a nonconventional source is now allowable without the requirement to make an election to claim the credit [Act Sec. 1322 of the Gulf Opportunity Zone Act, amending Section 45K(a)].

6.9.6 Relief granted for rehabilitation projects in hurricane areas

The IRS has provided relief to taxpayers who have rehabilitation credit properties located in areas affected by Hurricanes Katrina, Rita, and Wilma (IRS Notice 2006-38, IRB No. 2006-16). The relief prevents inadvertent recapture of the rehabilitation credit by giving property owners up to 36 months to repair property and return the property to qualified service. The deadline was similarly extended for property that was in the process of being placed into service when the hurricanes struck. To qualify for the relief, repair or restoration work on the project must begin on or before August 15, 2006.

Observation

The rehabilitation credit is available for the qualified rehabilitation of a building first placed in service before 1936, and for certified historic structures, regardless of when the building was placed in service. The rehabilitation credit is generally 10 percent (20 percent for certified historic structures) of the qualified rehabilitation expenditures [Section 47(a)]. However, an increased credit of 13 percent (26 percent for certified historic structures) of the qualified rehabilitation expenditures is allowed for eligible buildings located in the Katrina GO Zone paid or incurred after August 27, 2005, and prior to January 1, 2009 [Section 1400N(h)].

6.9.7 Long-distance telephone excise tax

After several defeats in the courts, the IRS has now conceded that the 3 percent federal excise tax of Section 4251 does not apply to long-distance calls for which the charges are computed on the elapsed time

of the call, regardless of the distance (IRS Notice 2006-50, IRB No. 2006-25). As a result of this change in position, taxpayers are no longer required to pay the 3 percent federal excise tax on telephone charges which are based solely on minutes of use and not on distance of the call. Additionally, refunds of tax amounts paid on services billed to a taxpayer after February 28, 2003 and prior to August 1, 2006 can be obtained.

Observation
Because both businesses and individuals have been paying the excise tax on long-distance calls, both qualify for refunds. However, the IRS has provided a safe harbor opportunity for individuals only to obtain a credit or refund of the tax previously paid.

Businesses, other than proprietorships, will only be able to claim a refund based on the actual telephone excise tax paid. Additionally, businesses who previously deducted the excise tax amounts as business expenses and who receive a refund will be required to include the refund amount in income for the year in which the refund is received or accrued, subject to the tax benefit rule of Section 111.

Individual taxpayers will be entitled to a refund of the long-distance telephone excise tax based on a standard safe harbor amount and will claim the refund on their 2006 Form 1040. Individual taxpayers using the safe harbor amounts are not required to submit or maintain any documentation. The safe harbor refund amounts for individuals are based on the number of exemptions claimed on the 2006 Form 1040, with one exemption entitled to a $30 refund, two exemptions to a $40 refund, three exemptions to a $50 refund, and four or more exemptions entitled to a $60 refund.

6.9.8 Foreign tax credit

6.9.8.1 Background
U.S. citizens and residents are taxed on their worldwide income, but because the country in which the income is earned may also impose an income tax, foreign-source income may be subject to double-taxation. To minimize the impact of such double-taxation, the Code provides a foreign tax credit to the taxpayer. The foreign tax credit limitation is separately calculated for various categories of income, currently separated into nine limitation categories, which typically vary a high or low rate of foreign tax, designed to prevent a distortion of the foreign tax credit.

6.9.8.2 Nine limitation categories reduced to two categories in 2007

The American Jobs Creation Act of 2004 enacted a provision, reducing the number of categories or "baskets" for purposes of the foreign tax limitation from nine categories to two categories. The two categories consist of a passive category income and a general category income, effective for taxable years beginning after 2006 (Act Sec. 404, amending Section 904).

Observation

Passive category income includes passive income, and also includes dividends from DISCs, taxable income attributable to foreign trade income, and distributions from a Foreign Sales Corporation or a former Foreign Sales Corporation. General category income includes all income other than passive category income.

Transitional Rule

For taxes paid or accrued in taxable years beginning in 2005 and 2006, taxpayers may elect to treat foreign or U.S. possession taxes on non-U.S. income as imposed either on general limitation income or financial services income [Section 904(d)(2)(H)(i)].

6.9.9 Credit for electricity produced from certain renewable resources

6.9.9.1 Background

A renewal electricity production credit is provided [Section 45(a)]. The amount of the credit is equal to the product of 1.5¢ multiplied by the kilowatt hours of electricity:

- Produced by the taxpayer:
  - — From qualified energy resources, and
  - — At a qualified facility during the credit period beginning on the date the facility was originally placed in service, and
- Sold by the taxpayer to an unrelated person during the taxable year.

The amount of the credit is reduced by an amount which bears the same ratio to the amount of the credit as:

- The amount by which the reference price for the calendar year in which the sale occurs exceeds 8¢ bears to
- 3¢

The energy credit for electricity production must be reduced by the amount of any other credit allowable with respect to any property which is part of the project [Section 45(b)(3)(A)].

6.9.9.2 Credit not reduced by state or local tax credit

The IRS has clarified that a state or local tax credit received for a wind-powered electricity production facility does not reduce the Section 45 credit (Rev. Rul. 2006-9, IRB No. 2006-9). Accordingly, the credit reduction only occurs if other federal tax credits are received, not state or local tax credits.

6.9.9.3 Electricity from wind turbines

In a private ruling, the IRS has determined that electricity generated from wind turbines qualifies for the Section 45 credit, provided the turbines were placed in service prior to January 1, 2008 (PLR 200620004). The electricity produced by the turbines was generated within an LLC owned by a holding company. In its ruling, the IRS found that the holding company was entitled to the credits for the electricity sold, with the credits then allocated among the members of the holding company according to the interest of each member in the holding company.

6.10 Corporate-owned Condominium

6.10.1 Background

A corporation generally cannot deduct an expenditure connected with an "entertainment facility," even if the entertainment is directly related to or associated with the active conduct of a business" [Section 274(a)(1)(B); Reg. Section 1.274-2(a)(2)]. Exceptions exist to the general rule, one of which applies when employees pick up compensation for personal use (but see the limitation in 6.10.3, following).

6.10.2 Definition of entertainment facility

An entertainment facility is any property owned or rented and used for entertainment, recreation or amusement [Reg. Section 1.274-2(e)(2)(i)]. This particular regulation goes on to state that "Examples of facilities which might be used for, or in connection with, entertainment include yachts, hunting lodges, fishing camps, swimming pools, tennis courts, bowling alleys, automobiles, airplanes, apartments, hotel suites and homes in vacation resorts."

6.10.3 Exceptions to nondeductibility rule

Section 274(e) details a number of exceptions under which the general nondeductibility rule of Section 274(a)(1)(B) can be avoided. One of these exceptions is detailed in Section 274(e)(2), which was modified by the American Jobs Creation Act of 2004. Prior to amendment by the

2004 statute, this exception basically allowed the full deductibility of expenses associated with entertainment facilities when the taxpayer picked up compensation income related to the use.

This particular exception gave rise to significant litigation, culminating in an Eighth Circuit decision upholding a previous Tax Court ruling, which determined that there was no direct linkage between the amount of the employee's taxable income and the amount of the employer's deduction when employee income amounts are imputed (*Sutherland Lumber-Southwest, Inc. v. Comm.*, CA-8, 7/3/2001, aff'g. 114 TC 197, 3/28/2000).

In the *Sutherland Lumber-Southwest* ruling, the taxpayers picked up income amounts imputed under the so-called Standard Industry Fair Level (SIFL) formula, amounting to a compensation amount of approximately $35,000 that was included in their wage income for personal use of a corporate aircraft. However, the corporation incurred expenditures allocable to the aircraft for the personal flights in an amount of approximately $370,000 for the year. Again, the Eighth Circuit upheld the Tax Court in determining that the entire $370,000 amount was deductible to the corporation, even though the personal use of the aircraft was by "control employees." The IRS Chief Counsel's office then followed up with a private ruling that an S corporation could fully deduct the expenses of a corporate aircraft, even though there was significant personal use by a shareholder (CCA 200344008).

Sensing the extreme abuse that could be caused under the Eighth Circuit ruling in *Sutherland Lumber-Southwest,* Congress amended Section 274(e)(2) under Act Sec. 907(a) of the American Jobs Creation Act of 2004. In fact, the Committee Report to this legislation indicates that the "provision is intended to overturn *Sutherland Lumber-Southwest, Inc. v. Comm.* with respect to covered employees." The net impact of this legislation was to limit the corporate deductibility of expenses to the amount that a "control employee" (or "covered employee") actually picks up in income. As an example, if the SIFL formula produces $35,000 of wage income, the corporation could only deduct $35,000 of aircraft expenses, even if the actual expenses were significantly higher.

6.10.4 Insubstantial use of an entertainment facility

Reg. Section 1.274-2(e)(2)(ii) specifies that "A facility used only incidentally during a taxable year in connection with entertainment, if such use is insubstantial, will not be considered a 'facility used in connection with entertainment' for purposes of this section."

However, the heading to Reg. Section 1.274-2(e) is entitled "Expenditures paid or incurred before January 1, 1979, with respect to entertainment facilities. . . ."

The courts have ruled that any facility used for entertainment, even where such use is incidental, is considered an entertainment facility (*Frisbie v. Comm.* TC Memo 1990-419; *Ireland v. Comm.*, 89 TC 978; *Mediaworks, Inc. v. Comm.* TC Memo 2004-177). In *Ireland*, the court noted that "the incidental use exception contained in Section 1.274-2(e)(2)(ii), Income Tax Regs., applies only to expenditures paid or incurred prior to January 1, 1979." Similarly, in *Mediaworks*, the court noted that "the term 'facility' includes any item of real or personal property which is owned, rented, or used by a taxpayer in conjunction or connection with an entertainment activity." The court went on to note that the term "entertainment facility" includes "houses (such as beach cottages and ski lodges)." While the Court in *Mediaworks* found that expenses related to use of a corporate boat were not "ordinary and necessary," it went on to clarify that even if the expenditures had been found to be ordinary and necessary, the amounts would have been disallowed under the "entertainment facility" rules of Section 274(a)(1)(B).

6.10.5 Potential capitalization of nondeductible costs

Section 266 allows for the capitalization of "carrying charges," under regulations prescribed by the IRS, to be chargeable to the capital account with respect to such property if the taxpayer so elects. However, Reg. Section 1.266-1(b)(2) provides that "an item not otherwise deductible may not be capitalized under Section 266."

6.10.6 Reporting of cash transactions on Form 8300

6.10.6.1 Background

Any party receiving more than $10,000 in cash in one transaction, or two or more related transactions, in the ordinary course of business is required to file an informational report with the IRS (Section 6050I). IRS Form 8300, *Report of Cash Payments Over $10,000 Received in a Trade or Business*, is used to file the report with the IRS.

6.10.6.2 Failure to file deemed inadvertent

A car dealership that failed to report the receipt of more than $10,000 in cash related to four separate instances was able to avoid the penalty associated with intentional disregard of the rules, as a federal District Court determined the failure to be inadvertent, rather than intentional (*Tysinger Motor Co., Inc. v. U.S.*, DC Va., 4/7/2006).

Some years previous, the IRS had audited the taxpayer and imposed nominal penalties for failure to properly file Forms 8300. The taxpayer tightened its controls, conducted training sessions for employees, and

engaged in ongoing communication on the requirements with new and present employees. However, despite the new controls that were implemented, several years later upon audit, the IRS uncovered four cash transaction on which a Form 8300 had not been filed. The IRS assessed the maximum penalty of $25,000 on the taxpayer for each failure to file ($100,000 total).

In analyzing the matter, the court determined that over 3,000 automobiles had been sold by the dealer, but only eight of the transactions involved cash of more than $10,000. On four of these eight transactions, the taxpayer properly complied with the filing of Form 8300, but neglected to comply on the other four transactions. The court felt this was simply a mistake of the taxpayer, rather than willful neglect, and directed the IRS to refund the $100,000 penalty amount to the taxpayer.

6.11 Tobacco Program Buy-outs

6.11.1 Background

Congress terminated the tobacco marketing quota program and tobacco price support program in the American Jobs Creation Act of 2004. In order to compensate impacted taxpayers, the United States Department of Agriculture provided contracts to eligible tobacco quota holders and growers, authorizing payments in ten equal annual installments in fiscal years 2005 through 2014. The IRS has now issued guidance on the tax treatment of such payments.

6.11.2 Tobacco quota holders

Tobacco quota holders using the quota in the tobacco farming business and holding the quota for more than one year are allowed to report the gains under Section 1231. Accordingly, gains are treated as long-term capital gains, but losses receive ordinary loss treatment (IRS Notice 2005-57, IRB No. 2005-57; IR-2006-35, 2/23/2006). The quota payments are eligible for installment treatment, even if a Form 1099-S is issued by the United States Department of Agriculture in the year of sale for the entire 10-year total payment amount.

Owners are allowed to report the income under the installment method based on the annual payment received for that year. As long as the total payments under the contract do not exceed $3,000, all amounts can be treated as principal payments on the contract. However, if total payments exceed $3,000, a recharacterization of a portion of the proceeds as interest income is required, as the quota buy-out program makes payments in ten equal installments without interest. Amounts are not subject to self-employment tax, but they also are not

allowed for purposes of farm income averaging, as a tobacco quota is considered an interest in the land.

6.11.3 Tobacco growers

Payments to tobacco growers are determined by reference to the production or planting of tobacco by the grower during the 2002, 2003 and 2004 tobacco marketing years. Growers are entitled to a payment of up to $3 per pound of quota in ten equal annual payments in years 2005 through 2014. The IRS announced that the federal tax treatment of grower payments has not yet been addressed, but that the IRS expects to issue guidance shortly.

6.12 Disregarded Entities: Responsibility for Payroll Taxes

6.12.1 Background

In early 1999, the IRS issued guidance allowing either a disregarded entity or the owner of the disregarded entity to pay the payroll tax obligations of the owner (IRS Notice 99-6, IRB No. 1999-3). However, the owner of the entity was ultimately responsible for the payroll tax. Under this guidance, the owner of the disregarded entity needed to satisfy the obligation using its own name and separate employer identification number.

The IRS now indicates that confusion arose under this guidance, particularly where state employment tax laws were inconsistent with the federal laws regarding disregarded entities.

6.12.2 Proposed regulations issued regarding payroll taxes and disregarded entities

The IRS has now issued proposed regulations, substantially changing the rules, requiring disregarded entities such as a Qualified Subschapter S Subsidiary and other single-owner disregarded entities (e.g., LLCs) to be treated as the employer for federal payroll tax purposes (Prop. Regs. Sections 1.34-1, 1.1361-4, and 301.7701-2, REG-114371-05, 10/18/2005).

Accordingly, the disregarded entity is in fact not disregarded for payroll tax purposes and has a responsibility to file its own payroll tax return and make payment on its own payroll tax. However, despite being a disregarded entity for payroll tax purposes, the disregarded entity will continue to be disregarded for all other federal tax purposes.

Observation

The guidance in the proposed regulations represents a drastic change from the previous guidance issued in Notice 99-6. Previously, the IRS indicated the disregarded entity was not treated as the employer, but rather, the owner of the disregarded entity was the responsible party for purposes of the payroll tax rules.

The proposed rules are effective for payments made on or after January 1, 2006, but until the regulations are finalized, disregarded entities and their owners may continue to rely on the guidance issued in Notice 99-6.

6.13 Annual Versus Quarterly Payroll Tax Reporting

6.13.1 Background

Employers file Form 941, *Employers Quarterly Federal Tax Return*, each quarter reporting FICA taxes and income tax withheld. Some employers, such as agricultural employers, file Form 943, *Employers Annual Federal Tax Return for Agricultural Only Employees.* Form 943 is filed annually, while Form 941 is filed quarterly.

6.13.2 IRS releases new Form 944

The IRS has now released new Form 944, *Employers Annual Federal Tax Return*, allowing small employers to file payroll tax reports annually, rather than quarterly (IR-2006-2, 1/3/2006).

Observation

Based on IRS estimates, almost 1 million small businesses will now be able to file annually rather than quarterly.

To be eligible to file the new Form 944, the estimated annual employment tax of the employer must be $1,000 or less. Form 944 is available on the IRS web site at www.irs.gov.

6.14 Pilot Tip Reporting Program Announced for Food and Beverage Industry

6.14.1 Background

Both employers and the IRS have long struggled with proper reporting of employee tips in the food and beverage industry. In 1993, the IRS developed the Tip Rate Determination Program as a means of enhancing tip reporting compliance in the industry, while also attempting to

reduce taxpayer burden. This Tip Rate Determination Program extended two alternative agreements to employers operating food and beverage establishments:

1. The Tip Rate Determination Agreement, which required that tips be reported at or above a specific rate negotiated between the establishment and the IRS.
2. The Tip Reporting Alternative Commitment Agreement, which required that the employer provide ongoing education to tipped employees on tip reporting procedures.

Observation
Employers entering into either one of these agreements and complying with the terms of the agreement were not subject to challenge on IRS examination with respect to the amount of tips being reported as wages.

6.14.2 New pilot program announced to further promote compliance

The IRS has now released a new pilot program in the form of a voluntary tip reporting program for the food and beverage industry (Rev. Proc. 2006-30, IRB No. 2006-31). The program is called the Attributed Tip Income Program (ATIP) and has as its objectives the promotion of compliance, the reduction of disputes on audit, and the reduction of required filing and recordkeeping burdens. Food and beverage establishments are allowed to elect to participate in ATIP on a calendar year basis for each of the three calendar years beginning on or after January 1, 2007.

6.14.2.1 Benefits to participating employers

A number of benefits accrue to employers who participate in the program:

1. The IRS agrees not to initiate any tip examinations for any period during which the food and beverage establishment is in compliance with the ATIP agreement.
2. IRS notices and demands issued to the food and beverage establishment with respect to tips of the establishment for any period during which the taxpayer is in agreement with the ATIP terms are based solely on amounts reflected on:
   - Form 4137, *Social Security and Medicare Tax and Unreported Tip Income,* filed by an employee with Form 1040, or
   - Form 885-T, *Adjustment of Social Security Tax on Tip Income Not Reported to Employer,* prepared at the conclusion of an employee tip examination, or
   - The reporting of additional tip income by a participating employee

Participating food and beverage establishments are considered in compliance with the requirements regarding allocation of tips to participating employees for all periods during which the food and beverage establishment successfully participates in ATIP.

6.14.2.2 Benefits to participating employees

The IRS agrees not to audit the tip income of an employee with respect to a participating food and beverage establishment for any period during which the employee is a participating employee of an ATIP agreement, providing the employee reported the proper wage amount on the Form 1040 at a level at least equal to the attributed tips associated with the employee's work at the participating establishment and as reported on the Form W-2 issued to the employee.

6.15 Form 1099 Reporting of Tax-exempt Interest Income

6.15.1 Background

Under Section 6012(d), taxpayers required to file a tax return must report the amount of tax-exempt interest income received or accrued during the taxable year. The reporting of this tax-exempt interest income is relevant for a number of purposes, including the determination of eligibility for the earned income credit, determination of the amount of taxable Social Security benefits, and potentially for inclusion of qualified private activity bond interest as a preference item for purposes of calculating AMT.

6.15.2 Form 1099 required for tax-exempt interest paid

Interest paid on tax-exempt bonds is subject to the same information reporting requirements as interest paid on taxable obligations, effective for interest paid after December 31, 2005, [Act Sec. 502(a) of the Tax Increase Prevention and Reconciliation Act, amending Section 6049(b)(2)(B)].

Observation

The Committee Report gives no guidance as to which form is to be used to report the tax-exempt interest income. Presumably, either the present Form 1099-INT will be used, or a new information reporting form will be developed.

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1. INTRODUCTION

Adequate cash flow is a critical element in the ongoing success of a business. The management and projection of cash balances eclipse all other guides to fiscal well-being, because without sufficient cash to fund operations and expansion plans, a business cannot survive. Excess cash may indicate that a company's resources are not being used to the best advantage.

This chapter discusses four major concerns about cash resources:

— Cash management

— Projection of cash flow

— Uses of cash in cost control and operational efficiencies

— Maximizing sales revenue at least cost

1.1 Cash Management

The objective of an effective cash management system is to maximize cash flows on sales to quality customers in the shortest time possible, keeping related costs to a minimum. The impact that good customer service has on improving cash flows should not be underestimated. In today's environment of electronic funds transfers, the timing of receipts and disbursements is even more critical. For that reason, the cash management system needs to consider the level of cash buffer, or extra funds on hand, based on the volatility of cash flows and management's comfort level.

As interest rates fluctuate, so does the emphasis on cash management. Rising interest rates place demands on businesses and require more effective use of cash, particularly for larger businesses.

Cash management is also important to companies encountering liquidity problems along with profit compression. With more powerful computer capabilities, managers are better able to make informed cash decisions to get maximum use from this asset.

1.2 Cash Flow Projections

Mismatched timing of cash inflows and outflows, or the failure to predict cash requirements, can be fatal to any business. One of the most effective cash management tools developed by modern business is the cash flow projection. Such projections touch on all aspects of the company and include not only current issues, such as the aging of accounts receivable

and payable, but also prospective events, such as new product introductions, and anticipated market penetration, and movements in interest rates.

New or expanding businesses will find cash flow projections to be of critical importance. This is especially true for capital-intensive enterprises that are required to pay for ever-increasing goods and services well before collections occur. It is management's responsibility to implement procedures to accelerate the collection of funds while making the best use of trade payables.

Cash is projected in numerous ways using various key management indicators (such as financial ratios) and techniques (including automated simulation analysis). See the *Business Performance Measures* chapter for a complete discussion of key management indicators. Emphasis on different aspects of a company's cash projection changes as the company evolves through its life cycle.

The objective of a cash flow projection is to provide:

— An accurate prediction of cash sources and uses.

— Useful feedback on how cash management decisions are working to achieve management's objectives.

— Timely information that helps management anticipate and head off cash problems as well as assist in making decisions affecting profit margins, production levels, and sales activity.

2. DEFINITION AND OBJECTIVES

Cash management is the art of maximizing a business's cash resources by:

— Accelerating cash inflow.

— Delaying cash outflow.

— Establishing cost controls and pricing strategies.

— Reducing or eliminating unnecessary non-value added functions and activities.

Cash inflow can be accelerated so that the time lag between revenue generation and the arrival of usable funds in the company's checking account is reduced to an absolute minimum. Likewise, the time between the purchase of goods and services required for operations and the time that the company's payment check clears the bank can be maximized.

Accelerating cash inflows should not damage customer relationships or render the company noncompetitive in the marketplace. Slowing the cash outflow should not impugn the company's credit reputation or give rise to negative rumors about the company's financial viability.

Effective cash management is an art rather than an exact science. Its success often depends on management's ability to negotiate effectively with creditors, bankers, and the company's customers. It extends beyond management's control of cash flows to require a continual vigil over the right sales and control of costs, which is a responsibility of all employees.

2.1 Benefits of Cash Management

Modern cash management techniques benefit businesses in many ways. Generally, such benefits include more efficient use of corporate resources, lower interest costs, and tighter management control. Specifically, effective cash management allows for the following:

— *Management foresight.* Because an effective cash control program identifies the timing of cash inflows and outflows, management is afforded a look into the business's future cash position. Having reliable cash flow information available, managers can expect few surprises resulting from emergency cash requirements or underemployed cash receipts. Managers can also measure business development against projected goals and receive signals about necessary policy and procedure changes.

— *Financing alternatives.* Because the cash control system identifies future cash requirements on a routine basis, financing needs are known well in advance, and management has time to effectively negotiate the most advantageous credit facilities available. Also, since both the amount and the timing of cash needs are known, funding draws can be negotiated to occur no sooner than when needed.

— *Untapped resources.* Aggressive managers are constantly looking for ways to reduce working capital requirements. When cash becomes available, it can be used to reduce borrowings, to reinvest in the business, or to fund an outside investment.

— *Reduced interest expense.* Like any other asset, cash has a holding cost. Usually this cost is the business's aggregate borrowing rate. Companies that maximize cash utility rigorously control unnecessary borrowing. Working capital reductions are often achieved by measures such as accelerating collections of accounts receivable.

2.2 Overview of Cash Management Techniques

Cash management techniques generally emphasize efficient use of the company's cash resources. Cash is allocated to areas that require it and removed from areas that can get along without it. The inflow of cash is accelerated using a variety of techniques both inside and outside the company - generally with its customers and banking relationships.

Working capital reduction and cash inflow acceleration techniques implemented inside the company focus on areas that tend to accumulate working capital. One goal of effective cash management is to get out of the billing, receivables and collection business to the extent possible:

— *Billing.* Slow billing increases working capital requirements.

— *Collections.* Slow collections increase receivables and working capital requirements.

— *Receivables.* Rising receivables increase working capital requirements.

2.3 Overview of Analytical Techniques

The analytical techniques used to control cash range from very simple accounts receivable aging analyses to more complex automated financing simulation models. Simple financial ratios can quickly tell management where too much cash is needlessly accumulating or where the company is bleeding cash. Such ratios are generally in the areas of liquidity, activity, and profitability. See the *Business Performance Measures* chapter for a complete discussion and examples.

Computers play a key role in more sophisticated cash management techniques. The wide adoption of online banking has allowed even small businesses to obtain available cash balances from the company's bank accounts and sweep funds to and from the line of credit.

Simple spreadsheet models can be used to simulate prospective cash positions quickly and identify cash excesses and shortfalls for even the smallest businesses. This is important for ensuring an adequate line of credit is established to cover peak seasonal cash shortfalls.

2.4 Overview of Cash Management Decisions

Cash management is the art of using the customer's cash and conserving the use of your own cash while making quality sales so that, after deducting costs (product, functional and customer), the contribution to cash flow is maximized. Areas of cash management decisions include:

— *Customer credit policies.* Does the small business have sufficient clout and the abilities to enforce credit policies, even if it means turning away some sales?
— *Billing and collection policies.* Can the small business dictate customer payment policies or are they at the mercy of the customer?
— *Banking relationships.* Can the small business negotiate any concessions from the lender?
— *Inventory management.* Can the company adopt just-in-time inventory processes?
— *Financing and capital structure.* Not a day to day issue, but necessary to consider in strategic planning.
— *Long-term strategies.* Other decisions should be consistent with the overall business plan.

3. ACCELERATING CASH INFLOWS

Modern cash acceleration techniques employ an overall concept termed *cash concentration.* A *cash concentration system* encompasses all the various areas of the business that obtain cash and funnel it into a single usable account, called the *cash concentration account.* Although not formalized in most small businesses, this concept can be employed by businesses of any size.

Throughout the company, various opportunities exist to increase the velocity at which sales are converted to useful cash in the bank account. The first such opportunity exists with billing and invoicing.

3.1 Billing and Invoicing

The first step in identifying the extent of opportunity in the billing area is to assess the length of time it takes from sale to issuance of a bill to the customer or client. For example, if a business waits until the beginning of the new month to render invoices for goods sold or services performed in the prior month, there is a time lag of between one and thirty days between sales and invoice dates. This increases working capital requirements and gives customers additional time to pay.

A useful method of computing the time lag between sale and invoice is to take a representative sample of sales occurring for each day in a given month. This is compared with the day an invoice for each sale was mailed. A simple analysis of just such a time lag appears as follows:

ABC CORPORATION
Analysis of Sales and Billing Time Lag
Month of July 200X

Customer	*Sale Amount*	*Sale Date*	*Billing Date*	*# of Days*	*Weighted Av. # of Days*
1	$ 10,000	7-1	8-5	35	0.63
2	100,000	7-2	8-5	34	6.07
3	50,000	7-4	8-5	32	2.86
4	75,000	7-7	8-5	29	3.88
5	90,000	7-15	8-5	21	3.38
6	30,000	7-17	8-5	19	1.02
7	10,000	7-20	8-5	16	0.29
8	110,000	7-25	8-5	11	2.16
9	25,000	7-26	8-5	10	0.45
10	60,000	7-31	8-5	5	0.54
	$560,000				21.28

The weighted average billing time lag for the ABC Corporation is about 21 days. This means that its receivables have aged 21 days before the customers are even billed. This translates into an interest cost of approximately $3,300 using a 10% rate [($560,000 × 10% interest rate)/ 360 days] × 21 days = $3,267.

Small businesses have the most to learn from this exercise. The answer is to always bill at the time of shipment. Achieving the goal of getting payment as quickly as possible, in advance if possible, can be accomplished by setting expedited payment terms. Although the interest saving ($3,300 in this example) is not a fortune, attention to such details becomes worthwhile if enough holes can be filled in the cash management system.

3.2 Credit and Collections

The collections area can be an accumulator of working capital if it is allowed to get out of control. In the receivables and collections area, speed is management's major goal. There is a much higher probability of successfully collecting a receivable 30 days old amounting to only $10,000 than for one 180 days old that has been allowed to grow to $60,000.

Terms are frequently a part of the sales agreement on large transactions. Often businesses unknowingly give away part of their profit margin by not negotiating the form of payment (check, wire transfer of funds, bank check, and cashier's check), the time of payment, or the interest assessment on late payments. Such details are significant negotiating points with a company's customers.

The company's credit policy decisions affect the willingness of customers to buy from the company. Overly stringent credit policies may discourage customers who might then turn to competitors. Liberal policies, on the other hand, may cause a rise in bad-debt expense, an increase in collection costs, and a greater concentration of working capital in accounts receivable. Proper balancing of credit policies should consider collection costs and whether increased interest expense needs to be reflected in product-pricing decisions.

Collection activities are a necessary part of every business, but should be considered a last resort. Devoting significant resources to collection activities may be an indication of internal operational weaknesses; that is, selling to the wrong customer without adequate analyses. Techniques available to small businesses include the following:

— *Dunning letters and phone calls.* These serve to remind the customer that the company is serious in its collection efforts and will pursue all remedies available to successfully collect its receivables.

— *Credit manager.* This employee's duties include establishing credit policies, approving credit terms to customers, and overseeing collection efforts.

— *Law firms.* A letter from the creditor's law firm explaining the consequences of not paying a bill is often enough to trigger payment. Legal remedies often are a last resort, as they are expensive and tend to offend valued customers.

— *Credit insurance.* There are insurance firms that will insure a specified percentage of accounts receivable.

— *Factoring.* Receivables may be sold at a discount to a factoring firm. This technique is expensive, however, as it amounts to a discount on sales.

3.2.1 Electronic funds transfer

To achieve virtually immediate collection on accounts, more businesses are implementing electronic funds transfers (EFTs). Funds are required to be electronically transferred on receipt of the product. This virtually eliminates the time from sale to collection. Internet-based businesses typically use this through services such as PayPal. Credit card and Debit card payments also result in immediate collection.

3.2.2 Analytical techniques

Because many small businesses find it impractical to implement EFT and other such techniques, it is extremely important to monitor their

accounts receivable balances. A variety of analytical tools for monitoring performance include the following:

— *Aging analysis.* Aging reports usually include a complete listing of accounts receivable by customer, showing balances that are current or thirty, sixty, or ninety days and older. The aging report totals should tie to the total accounts receivable balance (see Section 6.2 herein).

  The aging report is used to identify customers that are delinquent in their payment habits. Such information is used to allocate collections resources more effectively. Sorting this data by geographic region or by salesperson allows management to quickly see trends developing in geographic areas or in the payment habits of customers sought by particular salespeople. Adverse trends can be mitigated by reallocating sales and marketing resources to other regions or adjusting the commission payment policy to pay only on the *collected* sale. Some companies require customers to advance escrow funds that are held on deposit and drawn against as sales are made. Future sales may be suspended until the customer replenishes the account.

— *Roll rate analyses.* The rate at which receivables are "rolling" from one aging bucket to another is called the roll rate. The resulting information indicates what percentage of receivables roll from the current to the thirty-day, sixty-day, and ninety-day aging buckets. This information is used to determine the effectiveness of a business's collection effort. For example, assume a company has an average of 10 percent of all sales rolling to the ninety-day bucket before collection. The most current roll rate analysis indicates, however, two things:

  - Over the past two months, the percentage of sales rolling to the ninety-day bucket before collection has steadily escalated from a 10 percent rate to 15 percent.
  - The roll rate from the thirty-day bucket to the sixty-day bucket has jumped from its normal 5 percent to 15 percent.

  From this information, management recognizes that a collection problem exists; it can project the increased interest cost and bad debt expense due to the problem, and it can identify which aging bucket is responsible. Armed with this information, corrective steps can be taken in time to control the damage.

— *Average collection period.* The amount of time sales are tied up in receivables is determined by dividing sales by 360 days. This result is then divided into accounts receivable. The higher the period, the more attention should be provided to collections.

— *Receivables to sales ratio.* This ratio is determined by dividing total sales by accounts receivable. A high turnover indicates a quick collection period and liquid receivables.

— *Order-entry controls.* Most modern automated order-entry systems integrate with the accounts receivable system. Integration is useful to the order taker in providing on-line real-time information regarding:

- Current receivable balance information.
- Credit limits placed on particular customers.
- Payment history of particular customers.

With this information, the order taker may implement management's credit policies immediately at the point of order for particular customers.

3.3 Inventory Control

Most non-service businesses have a substantial amount of working capital tied up in inventory. To the extent possible, an emphasis should be placed on getting out of the inventory business. But because inventory levels are influenced to a large extent by market demand and availability, inventory is one of the most difficult components of the working capital equation to balance.

In a manufacturing business, there are three types of inventory, each requiring a different emphasis:

— *Raw materials.* Reduce level as close to zero as possible by integrating vendors into the production schedule. The vendor becomes the raw materials storeroom.

— *Finished goods.* Reduce level as close to zero as possible by manufacturing for real customer orders and shipping as completed.

— *Work in process.* Place the emphasis on cost controls and quick movement through the production process.

3.3.1 Inventory control techniques

Inventory control directly relates to cash management because of the working capital tied up in physical inventory. There are several techniques even small businesses can employ to ensure that:

— Inventory levels are not inappropriately high, thus causing an unacceptable amount of cash to accumulate.

— Finished goods turnover is sufficient, demonstrating that management is purchasing salable products that can be converted to cash.

Techniques that cash managers employ to quickly determine whether the working capital required by the inventory operation is an efficient use of cash includes the following:

— *Inventory turnover.* The frequency with which inventory turns over indicates whether cash is tied up in inventory that cannot be readily sold. A low turnover rate indicates that cash is trapped in low-demand inventory. Inventory turnover is computed as follows:

$$\text{Inventory turnover} = \frac{\text{cost of goods sold}}{\text{average inventory}}$$

The appropriate turnover of inventory is directly affected by the profit margin of an item. Lower margin items require a higher turnover while a lower inventory turnover is more tolerable for high margin items.

— *Days of inventory on hand.* If a company has an inappropriately high number of days of inventory on hand, yet is still ordering more, management should know the reason why. The number of days of inventory on hand is calculated as follows:

$$\text{Days of inventory on hand} = \frac{\text{total inventory}}{\text{daily demand}}$$

— *Inventory concentration reports.* The cash invested in inventory segregated by frequency of sale illustrates how effectively working capital invested in inventory is employed. Inventory concentration reports include the following information:

- Inventory item by number and description.
- Number of items on hand.
- Unit cost and extended cost.
- Report segregated by the top ten best sellers and the bottom ten worst sellers.

— *Overstock reports.* The overstock report indicates those items for which the quantity on hand exceeds the maximum stock level determined by management.

— *Economic order quantity (EOQ).* The optimum size of an inventory purchase order is computed as follows:

$$\text{EOQ} = \text{square root of } [(2ap) \div s]$$

where:

a is the annual quantity of the item used in units.

p is the purchase order cost.

s is the annual cost of carrying a unit in stock for one year. The carrying cost of inventory includes allocated warehouse expenses and interest costs.

— *Safety stock.* To prevent out-of-stock shipping delays, inventory levels should not exceed requirements plus a *safety stock.* By projecting the probability of stock outs at varying levels of safety stock, management can ensure that excessive inventory is not accumulated in the name of safety stock (masking poor inventory control procedures).

3.4 Wire Transfers

A wire transfer is the electronic conveyance of funds from one bank account to another. Wire transfers are moved through the Federal Reserve system using its Fedwire mechanism. Funds received via wire transfer are termed to be *good funds* (that is, the funds may be used immediately and require no further clearing procedures). Because of the speed with which wire transfers move through the banking system and the fact that they convey usable funds, receipt of a payment via wire is desirable from a cash management standpoint.

Wire transfer payments received by a business reduce the following time lags that affect cash management:

— *Mail float.* This is the float that the payor enjoys from the time of payment check is written and mailed to the time it arrives at the payee's business. Mail float may be anywhere from a single day to a week or more. The mail is also a convenient scapegoat to account for late payments.

— *Internal float.* Once the payment check arrives at the payee's office, it must go through the mail room, be distributed to the proper individual, recorded, listed for deposit, and finally taken to the bank for deposit. Depending on how fast this process is, the internal time lag may be anywhere from a matter of hours to several days. Internal float may be eliminated by having the checks sent to a bank lockbox. The bank is made responsible for opening the mail and depositing the checks into the company's bank account.

— *Bank float.* This is float that the payor enjoys from the time the payment check is deposited in the payee's bank to the time it clears and the funds become usable. Bank float is most advantageous for international transactions as the implementation of Check 21 has virtually eliminated bank float throughout the U.S. banking system.

Because the wire transfer goes directly into the payee's bank account in the form of usable funds, all of the above floats are circumvented. However, as advantageous as the wire transfer is for the payee, it is an equal disadvantage to the payor. For this reason, the form of payment must be negotiated as part of the terms of purchase. Often, such negotiation may be completed so that both parties win. In return for the

accelerated cash flow, a certain type of payment provides the payee a price discount or some other concession that may be extended to the payor.

3.5 Lockboxes

Another common method of accelerating cash inflow is the lockbox. The lockbox is simply a central collection location that receives payment checks. Generally, the most efficient collection location is the bank in which a business' central checking account is situated. For businesses with a widely distributed customer base, a network of lockboxes is often implemented to cut down on mail float.

Lockboxes can be used for businesses which lack the staffing to prepare daily deposits and deliver them to the bank. Depending on the level of volume, the bank may offer manual wholesale processing for lower volume clients or fully automated high volume retail processing remittance systems.

Based on the level of checks coming into the company's lockbox and the average float on payments clearing the bank, a negotiated percentage of usable (termed available) funds from each day's deposits can be determined. This percentage, when multiplied by the deposits received, provides the cash manager with the amount of funds available for use. With this information, the cash manager can more precisely evaluate the company's daily borrowing requirements or funds available for investment.

3.6 Depository Transfer Checks

Depository transfer checks (DTCs) are generally used in conjunction with a network of lockboxes, providing a quick and inexpensive method for transferring funds from outlying banks to a central cash account. The DTC is a non-negotiable preprinted check payable to the designated company account. The account owner authorizes issuance of DTCs by phone or online banking.

3.7 Direct Debit, PACs, PADs, and ACHs

These tools allow the cash manager to further accelerate the speed at which cash flows into the business.

— *Direct Debit.* Direct debit processing transfers funds from a customer's bank account into the seller's account. The system eliminates the need for checks to be mailed, and simplifies automatically recurring

billing by allowing payments to be accepted via phone, internet or recurring billing without a check.

— *Preauthorized checks (PACs).* The PAC is simply a preauthorized check. The preauthorized check allows a vendor that regularly provides goods or services to write itself a payment check on the customer's checking account. The time lag between the time of invoice receipt and payment is eliminated. PACs are limited to a maximum amount and require specific backup documentation to be forwarded to the customer.

— *Preauthorized Electronic Deposits (PADs).* The PAD is similar to a PAC except that instead of a check, it employs a wire transfer. PADs are used mostly for larger payments whose purchase terms provide for such a device.

— *Automated Clearing House (ACH).* The ACH network is a batch-oriented electronics funds transfer system which provides for interbank clearing of electronic payments for participating financial institutions. The ACH system moves a variety of transactions, including direct deposit of government benefit checks and payroll. It also transfers direct payment of electronic checks and other E-commerce payments.

3.8 Electronic Fund Transfer

A recent federal law known as the "Check 21 Act" makes it easier for banks to create and send electronic images of paper checks. Even before Check 21, banks were allowed to process checks electronically when all the banks in the process agreed. Under Check 21, any bank may create a special paper copy—called a "substitute check"—using images of the front and back of an original check. If any bank in the process requires a paper check, another bank can send a substitute check in place of the original.

Under an Electronic Fund Transfer (EFT) process, a merchant or other party (such as a utility company) can change the paper check into an electronic "debit" that is paid from the payor's checking account. The debit may be paid from the account much more quickly than if a check had been processed in the conventional way.

One kind of EFT uses the Automated Clearing House (ACH) network, by which a merchant or company converts a paper check into an electronic payment. For example, if a check is mailed to a credit card company, the company may convert that check to an ACH payment.

The company generally would destroy the original paper version and keep only an electronic image of the check.

4. DECELERATING CASH OUTFLOWS

The cash manager is responsible for preserving cash once it has been received by the business. To accomplish this, cash outflow is decelerated as much as possible by leveraging accounts payable. Trade accounts often do not carry an interest charge if paid within a certain time period. This does not imply that a firm should stop paying its bills or pass up early payment discounts. However, there is a difference between paying bills when customarily due and not taking advantage of the working capital costs the vendor has likely included in the product price. The company does not want to slow cash outflow to the point where its ability to obtain credit is diminished, unfounded rumors regarding financial stability begin to circulate, or suppliers refuse to deal with it.

There are two major areas where most businesses have an opportunity to improve cash utility by decreasing the rate at which funds flow out of the firm. These two areas revolve around the firm's payment function and include controlling payments and managing accounts payable.

4.1 Payment Control Techniques

Controlling the speed with which a business pays its liabilities can have a dramatic impact on cash requirements and allow the cash manager to preserve this expensive asset. The faster bills are paid, the greater becomes the requirement for working capital and the greater becomes the demand on the line of credit. One easy analytical method to determine the speed with which a business pays its bills is the *average age of payables analysis.*

4.1.1 Average age of payables

Computing the average age of payables informs the cash manager how long an invoice is retained before it is paid, thus indicating whether an opportunity exists to stretch the average payment times to more appropriately conform to customary industry standards without negatively reflecting on the business's reputation or vendor relationships. For example, if a business's average payable is aged only fifteen days before payment, whereas the industry standard is forty-five days, an opportunity exists to retain cash equivalent to thirty days of the payables

requirements. If a business is paying $1 million per month, stretching the payables by thirty days reduces the borrowing requirement by $1 million (at a borrowing rate of 10 percent, this translates to an annual interest savings of $100,000).

ABC CORPORATION
Analysis of Payables Aging
Month of July 200X

Vendor	*Invoice Amt.*	*Inv. Date*	*Pymt. Date*	*Weighted Av. # of Days*
1	$ 50,000	7-1-0X	7-15-0X	.40
2	75,000	7-2-0X	7-15-0X	.56
3	25,000	7-5-0X	7-15-0X	.14
4	10,000	7-7-0X	7-15-0X	.05
5	150,000	7-8-0X	7-22-0X	1.21
6	5,000	7-8-0X	7-22-0X	.04
7	90,000	7-12-0X	7-22-0X	.52
8	1,000,000	7-15-0X	7-29-0X	8.07
9	250,000	7-21-0X	7-29-0X	1.15
10	80,000	7-29-0X	7-29-0X	0.00
	$1,735,000			12.14

The weighted average number of days can be determined by multiplying the percentage of total July invoices that each invoice represents by the number of days between an invoice and its payment date, then adding the weighted days. Thus, the weighted average number of days is a little over twelve days. For most businesses, such a payment policy, while promoting a certain amount of goodwill among its vendors, exceeds what is customary. If ABC could stretch its payable policy to thirty-five days before payment, the annual interest savings would be approximately $129,000, assuming a 10% interest rate, computed as follows:

Average monthly payables:	$1,735,000
Number of days payables are stretched:	23
Daily payables cash requirement: $1,735,000 ÷ 31 =	$ 55,968
Cash retained by stretching payables 23 days:	
$55,968 × 23 days =	$1,287,264
Interest savings:	
Cash retained of $1,287,264 × 10% interest =	128,726

Many businesses set up payment dates that are on a regular basis, such as every week, regardless of when the invoice hits the accounts payable system. Such rote management of payables is not unusual, but

it can be costly. Most modern accounts payable systems allow management to request a listing of invoices that are a designated number of days old for payment. Using this technique, obtaining control of accounts payable payment terms is relatively easy.

Also see section 6.4 herein for a sample accounts payable aging report.

4.2 Management of Accounts Payable

In addition to managing the timing of accounts payable payments, overall management of a firm's payables is an effective technique to slow the speed with which cash flows out of the company. This begins with the negotiation of the terms of large purchases. Points eligible for negotiation to better manage accounts payable include:

— Type of payment, such as wire transfer, check, DTC, and so forth.

— Date of payment.

— Progress or partial payments.

— Discounts if paid prior to due date.

Each of the above payment terms, if ignored during negotiations, increases the overall cost of purchase. If aggressively pursued by the negotiating team, the overall purchase cost declines.

4.2.1 Purchase discounts

Purchase discounts are a reward to the payee for promptly paying invoices. In essence, the vendor is compensating customers for the interest costs they incur by paying bills early.

Generally, if cash is available, it is good policy to take advantage of discounts whenever they are offered.

When formulating discount payment policy, one criterion that should be considered is the discount offered cut-off point. This means the point where the cost to pay early (in terms of interest expense) equals the benefit derived by early payment.

Computation of the business's point of indifference with respect to purchase discounts is as follows:

[Discount percent ÷ (due date − discount date)] × 360 days = Annualized interest income from taking advantage of the discount.

For payment terms of 1% / 10 days, net/30, the interest rate is computed as follows:

$[.01 \div (30 - 10)] \times 360 = 18\%$

5. USE OF BANKS

The banking system itself can assist the cash manager in achieving both goals of accelerating cash inflow and decelerating cash outflow without undue cost or management effort. This section discusses some of the common uses of bank float, remote disbursement techniques, sweep accounts, and banking relationships.

5.1 Float

Float is the time it takes funds to move through the banking system. When a business is collecting funds, the objective is to minimize bank float. When disbursing funds, management wants to stretch the time between check disbursement and check clearing.

A cash manager's objective is to take advantage of the benefits inherent in the banking system without abusing it.

The adoption of Check 21, with its electronic clearing of payments, has removed most of the float from the banking system.

To minimize the time required to clear receipts through the banking system, a cash manager employs some or all of the following float techniques:

- Lockbox system, which minimizes the time it takes to move funds from the point of receipt to the company's central bank depository
- Depository transfer checks
- Wire transfer of large receipts to the cash concentration account

5.2 Choice of Banks

The choice of banking institutions can make a difference in how long it takes to have a company's payment checks clear through the banking system. Using remote disbursement banks may increase the mail float in the payables system.

If the chosen bank is not a member of the Federal Reserve system, this may further increase the time required for check clearing.

5.3 Sweep Accounts

Sweep accounts are very popular with businesses that cannot earn interest on checking accounts. A sweep account allows the cash manager to keep only the amount of money required for check clearing that day in the non-interest-bearing demand deposit account (DDA). All other

balances are "swept" into an interest-bearing account. Such accounts relieve the manager of the need for precise calculation of how much money will be required to fund daily check clearings, including a small cushion. This technique may also be used in connection with businesses that have branch locations. Funds may be swept from the branch bank account to the home office bank account (see section 5.4, below).

A close cousin of a sweep account is the zero-balance checking account. Such an account maintains a zero balance, drawing just the amount of funds required for checks clearing into it from an interest-bearing account.

Sweep account drawbacks can include the high cost per transaction and a lower yield on the interest-bearing account than could be obtained on excess funds placed independently. Yet, the sweep account provides an alternative to leaving idle funds in a non-interest-bearing checking account over the amount required for compensating balance purposes.

5.4 Cash Concentration Systems

A cash concentration system automatically channels funds from every source of the business into a single usable account. Such a system allows the cash manager to quickly identify available funds each day, move the funds to accounts that will have funding requirements that day, and invest the remainder in overnight repurchase agreements, short-term commercial paper, or other interest-bearing instruments until needed.

The mechanism of the cash concentration system was previously discussed under depository transfer checks (DTCs), preauthorized electronic deposits, and the sweep account. The objective of the concentration system is to automatically transfer daily all funds from outlying checking accounts into the single concentration account.

A reliable cash concentration system reduces the cash balances left in accounts or other vehicles that underemploy, or worse, do not employ, funds that would otherwise be available for the cash manager's use. An additional benefit of the concentration system is that often the utility of ancillary accounts begins to be questioned, and the number of bank accounts can be dramatically reduced. The fewer the accounts, (1) the less likely available funds will remain idle, (2) the less effort is exerted in monthly account reconciliation, (3) the more remote the possibility of unauthorized check writing on a seldom used account, and (4) the lower overall bank charges.

A concentration system should work every day the bank or the post office is open. Many post offices provide mail service on Saturdays. Even

if the bank is not open for check processing on Saturdays, the company's staff should collect and process checks received and prepare them for deposit on the next business day. If Saturday check receipts are high enough, the interest savings will justify the additional staff cost.

5.5 Funds Availability

Availability of funds refers to the amount of funds in an account that have cleared through the banking system. Funds are said to be available when they are collected by the cash manager's bank (in which the checks were deposited) from the payor's bank. Funds availability can be negotiated.

Most businesses receive monthly checks from the same or similar customers. Using a historical period, the cash manager and banker can compute how long it takes the average check to clear through the banking system. From this analysis, the banking agreement can provide for availability of a specified percentage of daily deposits the same day, the next day, in two days, and so forth.

A business might improve availability of funds from three days on 100 percent of deposited funds to the following tiered system:

— Same day availability: 20% of deposited funds

— Next day availability: 75% of deposited funds

— Two-day availability: 5% of deposited funds

The following cash is thus freed from the banking system:

Daily cash deposits:	$1,000,000
Under the old system of availability, interest cost on idle funds was	
[($1,000,000 × 10%) ÷ 360] × 3 days =	$ 833
Under the new system, interest cost on idle funds was	
[($1,000,000 × 75% × 10%) ÷ 360] × 1 day =	$ 208
Plus [($1,000,000 × 5% × 10%) ÷ 360] × 2 days =	28
Total interest cost on idle funds per deposit =	$ 236

By negotiating funds availability with the bank, the above example saved $597 ($833 – $236) in foregone interest income on idle funds for each deposit, assuming a 10% interest rate. Assuming that deposits are made five days per week, fifty-two weeks per year, this amounts to $155,220 per year.

Funds availability is a point many bankers are willing to negotiate, particularly if it means the difference in obtaining a new blue chip customer or keeping a valued customer. It is the cash manager's responsibility to specify the funds availability that meets cash management requirements.

5.6 Account Analysis

Banks often send out account analysis statements to their corporate customers. These statements summarize a variety of things related to average collected balances, year-to-date balances, loan covenants as related to compensating balance, and bank service credit for outstanding balances.

Cash managers should monitor closely the account analysis statement to determine just how much the business is paying for banking services. The objective is to honor the terms of the banking agreement, but not to overcompensate the bank.

Many businesses have an opportunity to free cash from compensating balances that are overfunded. The account analysis statement summarizes the average and year-to-date balance in the compensating balance account(s). The cash manager should first compare these numbers with his or her own year-to-date balances in these accounts to be sure the bank did not make a computational error. Secondly, the agreement that produced the compensating balance (usually a loan agreement) should be reviewed to determine if the bank is appropriately compensated. If the bank has been overcompensated, steps should be taken to address this issue.

5.7 Banking Relationships

The banking relationship can be among the most valuable maintained by a business. The bank should be treated as a valued investor. The cash manager/treasurer is responsible for maintaining the banking relationship. To help to maintain that relationship:

— The bank should be sent quarterly and annual financial statements without being asked. Usually, such statements are part of any loan covenant.

— The bank should be kept informed of all major developments in the business.

— The board of directors or owners should meet with the bank several times each year to maintain a close personal relationship.

Finally, even though the relationship with a firm's present banking institution may be excellent, management should continue to cultivate associations with other banking executives. Some firms go so far as to draft stand-by lending agreements with other banking institutions. These agreements are specifically designed to provide credit facilities in the event the business turns downward and normal credit facilities are withdrawn by the present bank.

5.8 Investment of Excess Cash

Investment of excess cash involves the three watchwords of cash management: safety, liquidity, and yield. Above all, whatever the instrument of excess cash investment, it must provide a risk factor acceptable to the business. Second, the investment must be available for conversion back into cash at the required time. Finally, the investment must yield an acceptable return. These three concepts tie in with the saying that "There is a rate for every risk." In other words, the higher the interest rate, the higher the risk factor.

The most commonly used short-term investment instruments for excess cash include:

— *Repurchase agreement (repo).* A repo is a contract with a bank or brokerage firm whereby the investor loans excess cash, taking acceptable collateral as security (usually a government security). The bank or brokerage firm is contractually obligated to repurchase the loan at a specified time. The terms of repos range anywhere from overnight (the most common) to thirty days or more.

— *Commercial paper.* Most firms offering short-term commercial paper are rated by Moody's and/or Standard & Poor's, thus providing an index of risk.

— *Money market funds.* Some firms use their money market funds as a short-term method of employing excess cash.

See also the chapter on Investment Vehicles for a discussion of other investment instruments.

5.9 Lines of Credit

Lines of credit (LOCs) have essentially become a necessity for doing business. LOCs range anywhere from tens of thousands to hundreds of millions of dollars. Terms of LOCs are negotiable with the bank. Most terms include:

— A maximum draw of the LOC, in effect, the credit limit.

— An interest rate charged, usually a fixed amount above an interest rate index, such as the prime interest rate.

— A commitment fee, which is a charge for the unused portion of the LOC, usually a percentage (one-quarter or one-eighth of a point) of the undrawn line.

— A clean-up clause. Many banks require the entire line to be repaid for a specified period of time during a twelve-month period.

— Loan convenants. Some LOCs specify that certain financial milestones be met (often stated as sales or financial ratios). Failure to meet such covenants places the firm in default.

6. CASH MANAGEMENT REPORTS

Four cash management reports are indispensable to most cash managers. These reports are

— Available cash report.

— Aged accounts receivable.

— Cash requirements report.

— Accounts payable aging.

Examples of each of these reports are included on the following pages.

6.1 Available Cash Reports

From the available cash report, cash managers have knowledge of cash that may be available in the next few days. This report could be projected for a longer period or periods such as weekly or monthly.

Note the following:

— All deposits are available for use within three days. The percentages used tie in with the guaranteed funds availability specified in the banking agreement.

— All disbursements are scheduled to clear within five days. The percentages are derived from experience.

ABC CORPORATION
Analysis of Available Cash
As of July 25, 200X

	Day 1	*Day 2*	*Day 3*	*Day 4*	*Day 5*
Beginning cash balance	$500,000	$677,500	$ 930,000	$1,066,250	$1,306,250
Anticipated cash receipts	250,000	300,000	200,000	400,000	100,000
% Available from day 1 (75%)	187,500	225,000	150,000	300,000	75,000
% Available from day 2 (20%)	0	50,000	60,000	40,000	80,000
% Available from day 3 (5%)	0	0	12,500	15,000	10,000
Total available receipts	$187,500	$275,000	$ 222,500	$ 355,000	$ 165,000
Scheduled disbursements	(100,000)	(75,000)	(250,000)	(200,000)	(50,000)
% Clearing day 1 (10%)	(10,000)	(7,500)	(25,000)	(20,000)	(5,000)
% Clearing day 2 (15%)	0	(15,000)	(11,250)	(37,500)	(30,000)
% Clearing day 3 (50%)	0	0	(50,000)	(37,500)	(125,000)
% Clearing day 4 (20%)	0	0	0	(20,000)	(15,000)
% Clearing day 5 (5%)	0	0	0	0	(5,000)
Total cleared disbursements	($10,000)	($22,500)	($86,250)	($115,000)	($180,000)
Ending available cash balance	$677,500	$930,000	$1,066,250	$1,306,250	$1,291,250

— The ending balance of one day becomes the beginning balance for the next day.

6.2 Aged Accounts Receivable

The following is a sample of an aged accounts receivable report as discussed in section 3.2.2 herein.

ABC CORPORATION
Accounts Receivable Aging
July 200X

Customer Name	*Current*	*30–60 Days*	*60–90 Days*	*Over 90 Days*	*Total*
333 Bush Street	$ 0.00	$ 0.00	$0.00	$ 315.00	$ 315.00
Asian American	236.36	236.25	0.00	708.75	1,181.36
AT&T	0.00	3,207.05	0.00	60.00	3,267.05
BAR/BRI	0.00	0.00	0.00	250.00	250.00
Carnevale	0.00	0.00	0.00	525.00	525.00
City Cycle	0.00	0.00	0.00	150.00	150.00
Egghead Software	0.00	0.00	0.00	8,896.00	8,896.00
El Dorado	1,181.70	1,181.70	0.00	0.00	2,363.40
Elite Modeling	340.00	0.00	0.00	149.62	489.62
The Equitable	190.00	190.00	0.00	341.50	721.50
Fong & Associates	0.00	346.50	0.00	1,323.00	1,669.50
Foot Locker	0.00	0.00	0.00	315.00	315.00
French Hospital	548.62	548.62	0.00	0.00	1,097.24
Gaylord India	0.00	0.00	0.00	75.00	75.00
Harbor View	0.00	0.00	0.00	1,050.00	1,050.00
Accounts Receivable	$2,496.68	$5,710.12	$0.00	$14,158.87	$22,365.67
	11.16%	25.53%	0.00%	63.31%	

6.3 Cash Requirements Report

The cash requirements report illustrates payables that must be paid within the time frames shown in each column to keep from becoming delinquent. This report is used to determine how much cash is required to honor the firm's payables commitment (see page 27).

6.4 Accounts Payable Aging

The accounts payable aging report illustrates how old the firm's payables are for each vendor owed. Note, in the example on page 27, approximately 46 percent of the payables are aged over sixty days. See also section 4.1.1 herein for a discussion of the average age of payables.

7. CASH PLANNING TECHNIQUES

Modern cash managers use projections in much the same way a pilot uses the airplane's navigational instruments: to determine in which direction they are going and to make mid-course corrections.

ABC CORPORATION
Cash Requirements Report

Vendor Name	*Current*	*10 to 20 Days*	*20 to 30 Days*	*Over 30 Days*	*Total*
Alhambra National Water Co.	$ 12.80	0.00	0.00	0.00	$ 12.80
Alphabetics	2,926.00	0.00	0.00	0.00	2,926.00
Cine Kerska Productions	8.52	0.00	0.00	0.00	8.52
Colorsplendor	4,742.00	0.00	0.00	0.00	4,742.00
CSC	758.83	0.00	0.00	0.00	758.83
Federal Express, Inc.	67.25	39.00	0.00	0.00	106.25
Graphic Sportswear	134.19	0.00	0.00	0.00	134.19
JLA Credit Corp.	0.00	176.18	0.00	0.00	176.18
City of Los Angeles	1,347.96	0.00	0.00	0.00	1,347.96
L'Image Photographic Lab, Inc.	464.86	0.00	0.00	0.00	464.86
	$10,462.41	215.18	0.00	0.00	$10,677.59
	97.98%	2.02%	0.00%	0.00%	

ABC CORPORATION
Accounts Payable Aging

Vendor Name	*Current*	*0 to 30 Days*	*30 to 60 Days*	*Over 60 Days*	*Total Payables*
Alhambra National Water Co.	$ 0.00	$ 12.80	$ 0.00	$ 0.00	$ 12.80
Alphabetics	0.00	1,426.00	0.00	1,500.00	2,926.00
Cine Kerska Productions	0.00	0.00	0.00	8.52	8.52
Colorsplendor	0.00	0.00	3,339.00	1,403.00	4,742.00
CSC	0.00	758.83	0.00	0.00	758.83
Federal Express, Inc.	70.25	22.00	0.00	14.00	106.25
Graphic Sportswear	0.00	0.00	0.00	134.19	134.19
JLA Credit Corp.	176.18	0.00	0.00	0.00	176.18
City of Los Angeles	0.00	0.00	0.00	0.00	0.00
On hold:	0.00	0.00	0.00	1,347.96	1,347.96
L'Image Photographic Lab, Inc.	0.00	0.00	0.00	464.86	464.86
Subtotal:	246.43	2,219.63	3,339.00	3,524.57	9,329.63
Total on hold:	0.00	0.00	0.00	1,347.96	1,347.96
Report total:	$246.43	$2,219.63	$3,339.00	$4,872.53	$10,677.59
	2.31%	20.79%	31.27%	45.63%	

Planning and the resultant projections fall into two major categories: strategic plans, which are long range and encompass the whole firm, and tactical plans, which are of shorter range and deal with specific segments of the business. Of the two categories, cash flow is usually included in the tactical plan. Cash flow projections provide a blueprint of how the cash and financing part of the business plan will be executed.

Most cash plans identify certain specific items critical to the cash manager function. These include:

— Cash inflows and scheduled cash outflows, such as loan repayments and cash dividends to stockholders, bond interest payments, and so forth.

— Financing requirements and excess cash balances that may be used to repay existing financing.

— Projected ending cash balance.

— Compliance with loan covenants and restrictions. Such covenants are often in the form of balance sheet ratios. Therefore, the cash manager must produce not only a cash plan, but balance sheet and income statement projections as well.

7.1 Approach to Cash Projections

The approach used to produce an accurate cash projection varies from business to business and according to the audience and uses of the end product.

Cash planning involves most areas of the business. Management's approach to formulating a cash plan should be one that considers all relevant input about the firm. A good example of this is the start-up costs of implementing a new manufacturing technique. The cash manager would need to know how much capital investment is required for plant and equipment and when payment must be made. Other costs and benefits such as labor, insurance, repairs, utilities, and sales are also considered. Additionally, the timing of each cost and benefit should be included in the cash plan.

In summary, cash forecasts involve the following steps:

— Project cash receipts (often as a percentage of sales)

— Project cash disbursements

— Compute net cash inflows and outflows

— Compute projected cash balance or shortfall

Formulating a cash plan should include the following four goals:

— *Predictive accuracy.* The plan must reliably project ending cash balances, financing requirements, and compliance with loan restrictions. Accuracy is achieved only through the underlying assumptions and mathematical relationships, so the plan's credibility depends largely on the information obtained from within the business.

— *Feedback value.* The cash plan should provide a source of feedback on execution of the original plan, so that adjustments can be made if actual performance goes astray. Thus, elements of actual performance and planned performance should be comparable, and deviations should be readily apparent.

— *Relevance.* The cash plan must be kept current and should reflect developments occurring throughout the enterprise. Not only relevance but credibility is impugned if an underlying assumption that affects cash is changed without recognition in the most current plan.

— *Timeliness.* To provide predictive value and relevance, the cash flow projection must provide timely information for decision making.

7.2 Presentation Format

Formatting the presentation of a cash flow plan is the first step in its creation. The cash manager should have a detailed idea of what schedules are to be included in the plan and how best to present the key performance and decision indicators. The format should also consider ease of entry for actual performance data to be compared with the plan. Finally, the plan should be formatted in such a way as to allow for quick updating and assumption changes regarding "what if" questions.

7.2.1 Planning with spreadsheet software

Although cash flow plans can be manually prepared, there are few reasons, other than lack of computer skills, to tackle this without the aid of a computer. The ability to run multiple scenarios with different assumptions simply makes computer spreadsheets invaluable. In preparing spreadsheets, it is important to dynamically link all calculated cells. All variable assumptions should be identified in one location to easily manipulate the assumptions for comparison of scenarios. To the extent possible, extract data from the business's accounting software by exporting reports directly to the spreadsheet. Internally prepared spreadsheets have a higher risk of errors, and therefore, should be closely reviewed for reasonableness and accuracy.

7.2.2 Planning with modeling software

Commercial software packages allow for interactive and dynamic linking of financial data contained in other file locations. Such software has the advantage over spreadsheets prepared in-house that the formulae have been independently reviewed for accuracy. Commercially available

modeling software may also provide real-time indications changes in projected cash flows.

7.3 Detail Required and Model Accuracy

The level of detail included in the cash plan should be the minimum required to fulfill all design requirements of the system. By making the cash planning system as simple as possible, less can go wrong with it, it is easier to understand, the cost of development and operation is lower, and it generally has a higher degree of reliability. Most experienced planners, given a choice, would rather have too little detail than too much. More detail can always be obtained. However, if too much detail is presented without enhancing the final work product, the cost of developing that detail becomes wasted effort because the same conclusions could have been reached without incurring additional development costs.

Model precision can be related to the reliability of the least accurate material assumption. For many systems, this is the interest rate forecast used to project interest expense. The model, by definition, can be no more accurate than the least reliable assumption contained therein. However, some assumptions have a larger allowable error tolerance because a minor misstatement would not change the conclusions reached.

7.4 Uses of the Cash Plan

The most obvious use, and the one for which the plan was originally developed, is to project cash requirements. However, because the plan crosses over most departmental lines of the business, and because it has the ability to identify actual performance that deviates from the plan, there are a variety of other uses. Some uses that may not be readily apparent initially include:

— *Inventory.* Accounts payable levels and movement is a component of most cash plans. If payables begin to deviate from the plan, one area that may be causing the change is inventory. There may be a variety of reasons, such as increased wastage, adverse material price variance, or changes in payment terms to vendors.

— *Receivables.* If receivables begin to increase, the cash plan will indicate an adverse deviation. This may point, for example, to a need for adjustment of geographic marketing concentration away from depressed areas. Additionally, if management has recently adjusted

the firm's sales commission policy to include collection of receivables rather than just sales, careful monitoring of the cash position impact of receivables will indicate the effectiveness of this decision.

— *Capital expenditures.* The cash plan can be used to help determine when capital expenditures can be made, when the most likely favorable financing can be obtained, and when the business will be able to repay the expenditure.

7.5 Decision Making Using Multiple Scenarios

Computing the cash plan under a variety of different assumptions simulates a range of contingencies under which the business can successfully operate. The cash plan should be executed at least three times, showing a best case, worst case, and most likely case. The required financing and ability to repay debt is then projected as a range rather than as absolute figures. Such a presentation will indicate that, as long as the assumptions specified in each of the three scenarios fall within the range, cash flow will be sufficient to maintain operations.

Additional decisions for which the cash planning system can be used under varying simulations include the following:

— *Sales price.* As previously discussed, payment terms help to determine the overall price received for a sale. Terms can be analyzed using the cash plan to determine the impact on cash position under various options. It may be discovered that a smaller price increase than the competition's can be made in exchange for less lenient payment terms without damaging the overall profit to the business.

— *Financing vehicles.* In terms of the business's cash flow, the optimum financing vehicle can be derived by simulating the various options available.

— *Performance of receivables and payables.* An assumption included in most cash plans is the time to collect an average receivable and the time an average payable is held. When formulating the firm's policies toward these two critical components of cash flow, multiple simulations may be run to determine the acceptable range for the policy. Again, it is possible that the firm can gain a competitive advantage in either its purchase of goods and services, or its sale of product by adjusting these policies, without endangering cash flow beyond the benefit created by the policy change.

7.6 Nine Steps to Cash Planning

There are nine key steps in producing a useful cash plan. They are summarized as follows:

— Describe exactly how the plan will be used.

— Identify the users of the plan, including who will create the plan, update it, and make decisions from its output.

— Identify the time period over which the plan will be used.

— Define the content of the finished product, including schematics of all reports, graphics, and sensitivity analyses.

— Define the degree of precision required of the plan, and work toward achieving that level.

— Identify the key causal relationships in the plan (termed *driver assumptions*) and the secondary assumptions that depend on the driver assumptions.

— Create the plan, preferably using an automated planning program.

— Validate the plan by entering historical data with a known result, activate the plan, and verify that the computed cash balances equal the already known results.

— Monitor actual performance against that which was planned and make adjustments in the plan to conform to changes that have occurred since the plan was developed.

7.7 Cash Management Warning Signs

Among the warning signs in identifying potential cash flow problems, the following also present opportunities available to improve a firm's cash position.

— Poor cash-related ratios, such as the current ratio, quick ratio, inventory turnover, receivables turnover, asset turnover, and profit margin.

— Excessive balances in non-interest-bearing accounts.

— A large number of bank accounts.

— Emergency borrowings resulting from surprise cash shortfalls.

— Lower-than-normal short-term investment returns resulting from surprise cash inflows.

— Unreconciled bank accounts.

— Slow collections and fast payments.

— Poor banking relationships.
— Poor availability of deposited funds resulting from a lack of float information.

No single sign indicates a problem; however, when taken as a whole and combined with a reliable cash plan, the analyst will get a good indication of the state of a firm's cash management effort.

8. INTEREST RATE RISK

The cash position and profits of many firms are unnecessarily eroded by movements in interest rates. Sensitivity to interest rate movements varies by industry. However, it is most pronounced in financial institutions and insurance companies, which rely on achieving a spread between interest income and interest expense. Cash managers need to be aware of their firm's exposure to interest rate risk and understand how to insulate their cash position and profits from unfavorable swings in interest rates.

8.1 Definitions and Symptoms

Interest rate risk occurs when a business has assets and liabilities for which the market value, earning power, and cost vary in relation to movements in interest rates.

As profits fluctuate, so do the firm's cash position, its requirement for outside financing, its earnings capacity, and its ability to attract additional investors and credit facilities. The range over which profits and cash balances move as rates change defines the boundaries of a firm's interest rate risk.

The objective of interest rate risk management is to minimize downside risk if rates go against the firm, while leaving the upside potential intact if rates stay the same or move in a positive manner. These seemingly are mutually exclusive goals. However, through a computerized process called *simulation analysis,* management is able to develop interest rate risk-control strategies.

8.2 Simulation Analysis

Simulation uses a mathematical computer model of the rate-sensitive portion of the business to simulate the effect on earnings and the

resulting changes in cash position caused by different risk-control strategies. The objective of simulation analysis is to find the best solution or combination of solutions to solve a firm's interest-rate-risk problem.

A typical simulation would perform the following two analyses:

— *Embedded risk.* This is the interest rate risk present in the balance sheet prior to attempting any control strategies. It is computed by assuming that the balance sheet remains constant while an earnings simulation is run through varying interest rate scenarios.

— *Identifying possible strategies.* Once embedded risk is identified, the effect of specific corrective strategies—such as swaps, floors, and restructuring of the balance sheet—is simulated. Once the embedded risk and possible alternative strategies are identified, management can begin to formulate a specific solution to its interest-rate-risk problem.

8.3 Formulation of Solutions

Controlling interest rate risk centers on creating an "insurance policy" against the effects of rate movement. Like a life insurance policy, one hopes it is never used. Most businesses coordinate their strategies to minimize rate risk immediately while restructuring their asset/liability portfolios and policies to achieve long-term control.

8.4 Protecting Profits and Cash

The objective of interest-rate-risk management is not to accurately predict where rates will go to take advantage of them. Rather, rate risk management seeks to insulate profitability and cash balances from changes in interest rates by combining short-term financial transactions, which take effect immediately, with longer-term strategies, which seek to implement overall risk-control policy over time.

9. FRAUD AND RISK MANAGEMENT

As cash flows through a business, the chance of theft and fraudulent misappropriation always exists. It is imperative that businesses guard against and minimize the opportunity for cash misappropriation. Strong internal controls are critical in minimizing the misappropriation of cash and increasing the likelihood of detecting misappropriation.

This section discusses techniques to reduce the threat of fraud and cash misappropriation and to establish sufficient internal controls to safeguard against fraudulent extractions of cash.

9.1 Guarding Against the Threat of Fraud

Businesses must develop appropriate strategies and implement policies to minimize the threat of fraud and misappropriation of cash. Several elements are involved in developing the appropriate strategies and policies:

— Determining acceptable risk levels

— Developing and implementing internal controls

— Developing and promoting an ethical environment

— Establishing appropriate insurance levels

9.1.1 Determining acceptable risk levels

A complete elimination of fraud and cash misappropriation can never be achieved, due both to prohibitive costs and to controls which would

(Text continued on page 38)

be so tight as to effectively shut down the efficiency of the organization. Accordingly, businesses must establish an acceptable level of risk and design controls associated with this level. In determining acceptable risk levels, the assessment of various risk factors needs to be completed. As an example, a business should assess the types of opportunities that might exist within the organization for individuals to misappropriate cash. Businesses then need to determine the risk tolerance for each factor and agree on the acceptable risk level associated with each individual risk.

9.1.2 Developing and implementing internal controls

To minimize the chance of fraud and cash misappropriation, estabishment of effective internal controls is paramount. Internal controls must be designed and implemented in all cases, even if the risk of fraud or cash misappropriation is minimal. At the same time, a system of internal controls should never ignore the risk of fraud or cash misappropriation, as this could result in a far too tempting environment for individuals who handle cash. Internal controls are discussed further in section 9.3.

9.1.3 Developing and promoting an ethical environment

A cash misappropriation prevention strategy needs to be centered around the existence of an ethical environment. Businesses need to establish and implement a formal code of business conduct and business ethics. Such a code of ethics and business conduct establishes the tone under which all employees are expected to operate.

9.1.4 Establishing appropriate insurance levels

Because some risk of fraud will always exist, businesses may need to "finance" this risk either through the purchase of insurance or internally through self-insurance.

9.2 Opportunity to Commit Fraud and Likelihood of Discovery

The opportunity to commit fraud or misappropriate cash refers to the ability of an individual to access the cash of the organization. As indicated in Section 9.1, no business can completely eliminate the opportunity for cash misappropriation; such opportunity will always exist in an organization.

Business Plans

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SUGGESTED REFERENCES

APPENDIX 1: Sample Business Plan Outline

APPENDIX 2: Sample Format for Financial Statement Projections (*also see Toolkit CD-ROM*)

APPENDIX 3: Business Planning Software

APPENDIX 4: Sample Cash Flow Statement Format (*also see Toolkit CD-ROM*)

APPENDIX 5: Sample Business Plan

APPENDIX 6: Small Business Administration (SBA) 8(a) Business Plan (*see Toolkit CD-ROM*)

APPENDIX 7: Succession Planning Checklist (*see Toolkit CD-ROM*)

1. INTRODUCTION

Business planning should be a continuing and central activity in every business. The greatest misconception about business plans is that they are nothing but sales documents used by start-up businesses. A business plan that is nothing more than a showpiece for raising money—for a start-up venture or for an existing business—probably will not succeed even at that.

For a business plan to be of real use, it must serve as a working document that owners and managers use to plan, control, evaluate, and manage their business. Any business, regardless of size, is more likely to be successful and profitable if it plans for the future, anticipates change, and carefully weighs its responses to an ever-changing environment. A business plan helps entrepreneurs, owners, and managers do the following:

— Define the objectives of a business and reach a consensus on how to reach those objectives.

— Allocate scarce resources—cash in particular.

— Obtain financing by gaining the confidence of creditors and investors.

Surveys show that many small (and many not-so-small) businesses consider accountants their most trusted business advisers. As such, accountants need to know how business plans are used to obtain debt financing or equity capital. They must also be able to show clients how to use business plans to help manage and control their businesses.

Accountants in industry have no less a need to understand how to do business planning. Their companies also frequently require outside financing, so they must be able to prepare formal presentations on the company's business, its financial goals and objectives, and how it intends to achieve those goals and objectives.

Even if an existing business does not seek debt or equity financing, a business plan is a way to ensure that owners and managers formally agree about the company's goals and objectives (which means extended discussion and reconciliation of conflicting views) and that all work cooperatively to make them happen. This type of long-range planning forces a business to rank opportunities according to priority and provides the framework on which a true management team can be built. In effect, therefore, a business plan is a budget written in general terms. It is an organized and systematic attempt to project all of a company's resources and influences, including finances, workforce, and market factors. The financial statements (or back end) of the business plan may be the heart and soul of the plan, but they do not exist in isolation.

Like a budget, an updated business plan is needed each year to tie the company's finances and short-term projections explicitly to its goals, objectives, strategy, and tactics in every important area, including marketing, production, operations, sales, and human resources. This will enable a company to remain both focused and flexible.

2. WHAT IS A BUSINESS PLAN?

A business plan is simply an attempt to be prepared for what is expected to happen in the future, to take control of those things that can be influenced and therefore to achieve the goals and objectives that have been set for the enterprise.

A business plan should be two things: a sales document to be used to obtain financing and also an overall operating plan for starting and running a business. It is important to remember that *it should be both.* The cash flow projections submitted to a bank by a long-time patron may be all that is required to demonstrate the need for an equipment loan that will help the company increase sales and profits. These projections, however, do not meet the criteria of being an overall operating plan.

In substance, business plans all share the same goal: to maximize the chances of success. In form, however, business plans vary considerably. The business plan for a start-up business and the plan for an existing business ordinarily would look substantially different, though they usually follow much the same outline. For example, while a well-established business may concentrate the presentation of its plan in the financial (cash flow) area, a start-up business will need to expend more effort in the marketing, production, and operations areas.

No two business plans look alike simply because no two businesses are alike. What ultimately determine how a business plan looks and what it includes are its *audience* and *purpose.* A plan for obtaining financing covers in detail what the business is (including its marketing and operating strategy and tactics) and how much capital the business needs to raise (including for what purpose), as well as projected financial statements and related analyses. But a business plan intended mainly to help owners and managers plan, control, and manage a business may look very different.

2.1 Start-Up Business Plans

Economic viability is what start-up business plans are about. New businesses fail at an appalling rate. The usual statistic cited in the press, by

academics, and in popular books about entrepreneurship is that four out of five start-up companies fail within the first five years (though studies suggest that the failure rate is lower).[1]

The elements usually cited in most business failures are:

— Management (lack of experience, education, sales ability, or just sheer incompetence).

— Inadequate capital (whether start-up or subsequent cash flow because of, for example, poor credit-granting practices).

— No planning beyond how to survive from one day to the next.

— Poor choice of business.

— Unfavorable location.

— Unplanned growth.

— Inadequate recordkeeping.

— Excessive inventory or fixed assets.

This list of reasons for business failures should make it clear that business planning for a start-up business is an attempt to recognize and deal in advance with the myriad obstacles and issues that a new business faces.

Start-up business plans are usually the most comprehensive and detailed. Business plans for existing businesses (particularly if the plans will not be used to raise capital from outsiders) are usually adaptations of the form and content of start-up plans, but may eliminate some of the detail in an effort to focus on overall objectives and more exact financial data.

2.2 Existing Businesses

Like start-ups, existing businesses need business plans for two basic reasons:

— To plan, manage, and control the business

— To raise capital

In many ways, plans for existing businesses should be much easier than business plans for start-ups. For example, projecting pro forma financial statements can begin with actual data, so the process has a stronger starting point. A company with several years' experience can (by considering historical data) better examine its operating policies and assumptions about the future, which is one of the most important aspects of planning.

[1]Buck Brown, "Business Failure Rates Aren't So Bad After All," *Wall Street Journal* (Friday, 20 May 1988), p. 27.

2.3 Summary Benefits of Planning and Goal Setting

The value of carefully conceived and continually revisited business plans cannot be overemphasized. In summary, they provide the following benefits:

Improved resource utilization—Goal setting and planning require management to evaluate the business's resources and thereby better determine capabilities and limitations.

Increased employee motivation—The unified company direction established by goal setting and planning underscores a "corporate culture," emphasizes mutuality and cooperation, and reduces employee anomie and frustration.

Improved understanding of opportunities, problems, and weaknesses—Planning involves programs and activities geared to assessing the business's environment—internal and external—and reacting positively to challenges and problems and taking advantage of opportunities.

Greater organizational control—Planning encourages and in some cases enforces adherence to project completion dates and performance standards essential to maintaining control.

Information for third parties—Written plans and objectives are useful in seeking financing, in planning mergers and acquisitions, and in a host of situations involving third parties.

3. CONTENTS OF A BUSINESS PLAN

Plans vary according to the type and complexity of the business, the stage of the business in its economic life cycle, and the intended purpose of the plan and its audience.

There are certain generally accepted formats for business plans. Usually, the narrative sections (descriptions of the business and the product) go up front, while the prospective financial statements—which are by far the most important component for most readers—usually go in the back.

Appendix 1, "Sample Business Plan Outline," provides a comprehensive overview of what a business plan might include.

Not all the information discussed in this section belongs in every business plan. The sample outline in Appendix 1 tries to cover all possible considerations, which makes it useful more as a checklist than as a model to follow for each and every business plan.

A business plan should not be cluttered with unnecessary detail. It should include objectives, major assumptions, concerns, and projected

results of the business, but should omit information and data that might obscure the main outlines of what must be communicated.

The following sections provide additional information about each major heading of the outline shown in Appendix 1.

3.1 Cover Sheet and Table of Contents

Cover sheets of business plans provide:

— The name and address of the business.

— The names, addresses, and phone numbers of the contacts (the lead entrepreneurs, ordinarily).

A cover sheet might also include a disclaimer about the projections, such as the following example, which has been adapted from the AICPA's Statements on Standards for Attestation Engagements, *Financial Forecasts and Projections,* and the AICPA Audit and Accounting Guide *Guide for Prospective Financial Information*:

> The projections in this business plan reflect our best judgment of the company's future operating results at the time this plan was prepared. The numbers used are based on expected conditions and our expected course of action. Since there will usually be differences between projected and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material, the planned results may not be achieved.

This paragraph, of course, contains the essential written representations that accountants must obtain from the client for a compilation.

If a plan contains important proprietary information, it might be advisable to include a paragraph, such as the one shown below, to restrict further distribution of the plan or disclosures of its contents:

> This business plan is being submitted confidentially. It contains proprietary information. You should not disclose the contents of the plan or distribute this or other copies of the plan to others without our authorization. By accepting this copy of the plan, you agree to these conditions and agree to return this copy upon our request.

When such a paragraph is to be included, it is generally advisable to obtain receipt signatures acknowledging the terms specified.

Although many business plans do not contain a table of contents, it makes sense to include one as a means by which readers can identify important elements in the plan and readily locate data.

3.2 Executive Summary

A typical venture capital firm probably receives numerous business plans every day, which means the time and attention devoted to any one plan is scant. Unless the executive summary can command the interest of potential creditors or investors, the remainder of the plan may never be read.

Whether a business plan is intended for outsiders or as an internal working document, the executive summary should be short and succinct—probably no longer than one page. A longer summary suggests the plan preparer is unable to see the "big picture" or focus on particular challenges. The summary should be prepared after the rest of the business plan is complete.

An executive summary must cause its reader to want more information. It should explain in broad terms what the company intends to do and how it intends to do it. These goals and objectives should be followed by a brief explanation of the resources that will be used in obtaining them.

The executive summary should briefly:

- Explain what the company's products or services are.
- Give an overview of the present market conditions and expected fluctuations.
- Review the industry.
- Explain the company's projected financial performance, discussing profitability and projected return on investment.

The executive summary briefly explains the company's critical success factors by setting forth its objectives, strategies, and tactics, and the internal and external influences affecting them.

3.3 Organization, Management, and Human Resources

This section should help provide answers to five questions:

- What business is the enterprise in?
- What management, key personnel, and employees are in place or available to make the venture succeed?
- What are the company's strengths and weaknesses, and what problems does it face?
- How much capital (and whether debt or equity) does the business need?
- How will the funds be used?

3.3.1 Organization

This section presents the basic facts about the business, such as:

- — A brief history of the business, including when the business began and (if applicable) the date and state of incorporation.
- — The legal form of business (for example, partnership, limited partnership, corporation) and its tax status (S corporation, C corporation, partnership).
- — The location of headquarters and principal offices.
- — Major successes or achievements to date.
- — Major problems or obstacles facing the company.
- — Risks and potential liabilities (insurability and coverage, potentially dangerous products, unasserted claims).
- — Funding required, specifying percentage of debt versus equity.
- — How funds will be used.
- — Current and proposed capital structure (common and preferred stock issued and outstanding, with descriptions of rights; major shareholders; long-term debt or bonds, with descriptions of each type; relationships with major banks; discussions of leverage and the pricing of additional equity interests).

3.3.2 Management and human resources

When asked what venture capitalists look for in a business plan, the response of one major venture capitalist was: "Three things—people, people, and then people."[2] Because events never turn out exactly as projected, a skilled and experienced management team is the best insurance a creditor or lender can have that a business can adapt to change. Such a team should be able to direct and focus a company toward the achievement of its objectives.

A business plan intended for outside use should explain relevant education and skill, business experience (including knowledge of the industry), and applicable technical knowledge. Depth of management is also important. Brief biographies are frequently presented, and detailed resumes are sometimes included in the exhibits section (see section 3.8 following).

Management alone cannot make a business successful. Other human resource issues should be covered, including:

- — Special technicians that are needed and their availability.

[2]Lawrence M. Alleva and Steven W. Barnes, "Marrying for Money: The Venture into Venture Capital," *Price Waterhouse Review*, 1988, no. 2:47.

— Current and proposed number of employees, with a breakdown of functional areas (for example, 55 manufacturing personnel, 12 supervisors, 3 managers, 4 administrative personnel).
— Availability of personnel in this geographic region or nationwide (and any special ability to attract personnel).
— Compensation and benefits policies (especially incentive performance programs).
— Union affiliations (current or foreseen).

3.4 Objectives and Action Plan

The section that explains the company's objectives and action plan draws all areas of an enterprise together—finance, marketing, and operations. It explains what the company wants to accomplish and by what means. Both short- and long-term objectives should be covered, which means also covering specific actions needed to meet both types of objectives.

3.4.1 Strategies and objectives

Business planning is projecting:

— What the entity will do with its resources.
— When it will do it.
— How it proposes to do it.

Objectives must be stated in terms that are measurable and based on specified intervals of time (for example, "by July 200X, sales will reach . . ."). A goal such as "obtain financing" or "reach our market" is of no value because achievement cannot be measured or gauged. Examples of objectives that are specific enough to include in a business plan are these:

— "Attain a return on equity of 40 percent by the fourth year of operation."
— "Increase sales by 50 percent per year for the first two years, then by 25 percent for the next three years."
— "Install 100 systems by the end of 200Y."
— "Capture a 15 percent share of the market by 200X."

3.4.2 Action plan

The action plan must explain how the objectives will be accomplished, relating them in terms of dates and priorities. It should tie together

management's or the owner's objectives (for example, to go public in five years after expanding sales by a factor of five), overall financial objectives (for example, specific return on equity and growth in sales amounts), marketing objectives (such as attaining a 10 percent share of the market by 200X), and the operating and production objectives (such as opening two new retail outlets on the West Coast, three in the Southeast, and four in the Northeast by 200Y).

This section also itemizes the specific and detailed steps that explain how these objectives will be accomplished: *who,* in other words, is responsible for doing precisely *what,* and by *when.*

3.5 Marketing

The marketing section of business plans should include:

— A discussion of the product or service.

— A market and industry analysis.

— Marketing objectives and strategies.

3.5.1 Product or service

The section that explains the company's product or service is especially important for start-ups as well as for going concerns that wish to add or expand a line of business. A company must be able to predict customers' needs and wants, because these define the business. The emphasis, therefore, should be not on what the company has to sell, but on what it offers that *people want or need to buy.*

The section on the product or service must make clear:

— What customers will be buying when they choose what the company sells.

— Why customers will buy the product or service from the company.

— Who in the market will make the buying decision.

If the company hopes to garner venture capital, it must usually have a proprietary product or a service that no one else can offer or that no one else can offer in the same way. The company's product or service must be explained in detail; often it is even appropriate to include illustrations, drawings, or photographs (either in this section or as one of the exhibits; see section 3.8 herein).

Brand names, if applicable, and prices should also be discussed and the product or service must be compared to the competition, which means discussing competitive strengths and weaknesses (such as price,

serviceability, distribution networks, warranties, timeliness, convenience, and prestige).

Results of relevant market research (whether primary research, like focus groups and surveys, or secondary research) can also be presented. Patents, trademarks, copyrights, franchises, and licensing agreements (owned, obtainable, and competing) should be covered.

The section on products or services must also take a broader view of what the company has to offer. Specifically, what are the implications of the company's product or services to customers or consumers?

The owners and managers of the business should identify such underlying assumptions so they can be evaluated objectively both within the company and by potential outside creditors or investors.

3.5.2 Market analysis

Offering a product or service that a company *thinks* customers need and want does not necessarily mean that a viable market already exists.

The market analysis covers:

- Who will buy the product or service.
- The size of the market.
- Projected sales.
- The projected growth of the industry and market.

A company whose "top line" (sales) is not big enough has no chance of having a satisfactory bottom line. Particularly with start-ups, the business plan must generally demonstrate the prospect of dramatic and sustainable growths in sales; otherwise, there's no use in starting up. To attract venture capital, in particular, growth must be emphasized. These matters are addressed first by analyzing the current status of the product or service. More specifically, the market analysis discusses:

- Customer preferences and needs (for example, whether preferences have changed or trends or events will influence preferences).
- Customers versus end users (for example, mothers who buy children's cereal).
- Demographics and segments of the market (age, gender, location, income, ethnic background, "lifestyle," values, and so forth) and how the company can reach them.
- Size, history, and trends in the market.
- The target market segments, including apparent market opportunities (geographical expansion, niches to exploit, new uses of the product).

— Market threats (new products, new technology, changing customer preferences).

3.5.3 Industry analysis

The industry analysis further considers the product or service in terms of the competition:

— Critical success factors in the market

— Important risks (for example, cheaper, knock-off imports or technological obsolescence)

— Barriers to or ease of entry into the market

— Stage and maturity of the market (take-off, growing, stable, or declining)

— Seasonality

— Sensitivity to business cycles

— Government regulation

— Normal credit policies

— Advertising and promotion

— Trends, fads, and the importance of innovations and technological changes (including possible obsolescence)

— Price sensitivity and possible product or service substitutions

— Major competitors, including their strengths and weaknesses, market shares, and prospects

— Location of competitors

— Varying methods and levels of distribution

— Important trade associations

— Varying sales methodologies (for example, salaried sales staff versus commission-only sales, direct marketing trade shows, and so forth)

3.5.4 Marketing strategy

The marketing strategy explains the company's marketing goals and objectives and tells how the desired results will be achieved. The strategy must follow logically and persuasively from the product or service analysis, the market analysis, and the industry analysis described in the three preceding sections.

The section on marketing strategy should answer questions about:

— Product or market attributes.

— Pricing policies.

— Development or evolutionary plans (spin-offs, organizational changes, mergers, acquisitions).
— Research and development efforts.
— Competitive responses.
— Distribution channels.
— Service or warranty policies.
— Credit policies.
— Advertising and promotion.
— Service and customer support.
— Sales personnel or direct marketing staffing and the compensation policies.

3.6 Production and Operations

The production and operations section covers how products will be manufactured or brought to market or, in the case of a service, how the service will be delivered.

The elements this section addresses include:

— Processes or equipment used.
— Facilities requirements.
— Sources of supplies, equipment, raw materials, purchased components, and direct labor (including plans for purchasing operations and hiring).
— Major components of operating expenses (labor versus direct materials) and the resulting cash flow implications.
— Inspections and quality control.
— Logistics (notably, how products or services will actually be delivered to customers, dealers, and brokers).

More specifically, the production and operations sections should include items such as these:

— A brief description of the manufacturing operations, purchasing operations (especially, for example, in the case of retail operations), or method of delivering services.
— Location and description of plants, warehouses, headquarters, and any other significant offices.
— Capacity and utilization.
— Expansion plans.

— Major fixed assets (current and planned).
— Make-versus-buy considerations.
— Quality control.
— Changes in production technology and threats from imports.
— Shelf life and potential obsolescence of inventory.
— Current and expected inventory turnover.
— Major suppliers (including their financial services, benefits, credit policies, locations, and risks of inadequate or subnormal supplies or availability).
— Major cost components (such as direct labor versus specific direct material costs).

3.7 Financial Presentations and Data

The heart of a business plan is the projected financial statements. They provide answers to the most fundamental questions about any business:

— What is the business worth now?
— What will the business be worth in the future?

Because value is a function of cash flows, including the initial investment and residual values, the cash flow statement is the first place to which a banker, venture capitalist, or any other sophisticated reader of a business plan usually turns.

The information that should be provided in this section about the company's future includes:

— The company's cash position.
— The company's projected financial performance.
— The company's financial position.
— The significant assumptions that underlie the projections.

Specific items included in this section include:

— Audited financial statements, including notes and audit opinions (existing companies).
— Detailed description of accounting principles and practices (new companies).
— Projected balance sheets, income statements, and cash flow statements for five years (usually monthly for the first year or two, then quarterly for the second or third year, and yearly thereafter).

— A statement of significant assumptions used in preparing the projected financial statements (such as interest rates, profit margins, inflation, turnover ratios, and expansion rates).

— Key financial ratios (past, if available, and projected).

— Cost/volume analysis (break-even).

— Sensitivity analyses.

3.7.1 Feasibility studies

Especially for start-ups, financial feasibility studies, which may consist of little more than projected cash flow statements, should be a first step. An entrepreneur who does not do a cash flow projection (or hire an accountant to do one) cannot truly understand the financial considerations with which the person is dealing.

A minimum of detail is needed in the initial figures to determine whether a proposed venture is worth pursuing at all. If the preliminary numbers look promising, a full-blown business plan with complete financial statements should be prepared, and detailed projections (particularly for all material sources and uses of cash) should be accumulated.

3.7.2 Different scenarios and time periods

Ordinarily, three different financial scenarios are covered in the prospective financial statements: the best case, the most likely case, and the worst case. Whether prospective financial information is considered a forecast or projection depends on the company's objectives. A *forecast* is defined by the AICPA Statement on Standards *Financial Forecasts and Projections* as prospective financial statements that present information that reflects conditions as they are expected to exist. A *projection* answers the question, What would happen if . . . ? Generally, in a business plan, the most likely scenario would be considered a forecast, whereas the best and worst case scenarios would be projections (see section 5.2.4 in this chapter).

Sales are usually the only variable changed in this type of sensitivity analysis, though other variables or assumptions could also be tested. See section 3.7.5 in this chapter for a discussion of "what if" analyses using computer spreadsheets and specialized software for projections.

The time horizon for presenting projected financial statements depends on the intended audience and their use of the business plan, as well as on how meaningful the projections will be. For example, trying to project more than five years into the future is probably a vain undertaking. But, whatever the time horizon in years, the periods for the first year, at least, should be months. Thereafter, quarters may be

used. Statements should, for the final year or two, show only yearly projections.

3.7.3 Assumptions

Unless the assumptions are documented and can be changed (for example, "40 percent growth in sales over seven years"), the projected financial statements and data are suspect, however well presented and mathematically correct they may be.

Among the assumptions that need to be discussed, analyzed, and documented are the following:

— Beginning and ending dates of the plan

— Appropriate time periods (months, quarters, years)

— Interest rates used on debt

— Interest rates used on short-term investments of excess cash

— Effective income tax rates (federal, state, and local)

— Growth in sales (for example, by a constant percentage, by product, in specific units sold, or in dollar increments)

— Capital expenditures

— Inventory levels maintained (turnover rates)

— Inflation

— Seasonality

— Business cycles

— Wage and salary growth

— Incentive compensation to be paid

— Service, replacement, and warranty costs

— Sales returns

— Accounts receivables collection periods

— Accounts receivables discounts taken

— Accounts receivables write-off rates

— Accounts payable payment periods

— Accounts payable discounts taken

— Aggregate gross margin for all products and gross margin by product line

— Dividend (or withdrawal) policy

— Accounting policies (for example, useful lives of assets, depreciation, and amortization methods)

— Tax policies (such as use of an accelerated depreciation method or the availability of the research credit)

— Beginning financial statement amounts (including assumptions about capital structure) for start-ups

— Debt or equity financing anticipated

See section 5.2 for a discussion of the reporting requirements imposed by professional standards regarding assumptions used in a business plan.

3.7.4 Detail and financial statement presentation

If historical financial statements (preferably audited) exist, they should be provided for the past three years. (See section 5.2 on professional standards when historical financial statements are included in a business plan.) Especially for start-up businesses, however, cash is most important, so this section focuses on cash flow statements from which the projected balance sheets and income statements can be derived.

The projected cash flow statements identify and provide for all possible cash inflows and outflows. A detailed buildup of budgets and schedules for all significant line items on the balance sheet and income statement is equally important.

Although all appropriate subsidiary budgets and schedules should be prepared, they should *not* all be included in the business plan. Many banks prefer specific formats, with many using Robert Morris Associates forms (www.rmahq.com). See Appendix 2, "Sample Format for Financial Statement Projections," also available on the *Accountant's Business Manual Toolkit CD-ROM,* for a sample projection form. Because many bankers receive their credit training using this form, and many former bankers are venture capitalists, using a familiar presentation is helpful.

Even if an original form is not used, its format (as reproduced on a spreadsheet) can be used to demonstrate the interrelationships between the financial statements and to show the effect that various decisions have on all three statements. The same data would be available from financial statements on separate pages, but seeing the offsetting effects all at once on all three statements often helps in understanding the important variables.

3.7.5 Use of spreadsheets and other business planning software

Most accountants are adept enough with spreadsheets to prepare templates for integrated financial statement projections. The template should be as general as possible so changing assumptions and facts will not invalidate prior programming. A general model can be used for

many business plans. For ease in updating, make a separate assumptions screen for every parameter that could conceivably change (for example, interest rates, returned sales, and day's sales outstanding). See section 3.7.3 for a list of assumptions used in a business plan and section 5.2 for a discussion of professional standards regarding assumptions.

Several commercial business planning packages are available. Appendix 3 lists many of them, provides a brief explanation of what they do, and includes Web addresses for further details.

3.7.6 Sales forecasts

The first step in preparing a cash flow statement is to project sales, after which other significant line items to be shown must be determined. Sales should be based on the market analysis (see section 3.5.2) done for the product or service. The sales forecast largely determines what must be accomplished by the various functions (such as manufacturing, marketing, personnel) of the business.

Existing businesses can usually predict sales figures with relative confidence; their main interest may instead be in controlling or reducing costs. For start-ups, however, estimating sales is the most important step, because if actual sales prove to be higher or lower than expected, the company's cash needs can increase or decrease significantly.

Forecasting sales can be especially difficult for high-growth start-ups, because their whole operating strategy depends on enormous and rapid increases in sales.

3.7.7 Cash flow statements

In its most basic terms, a cash flow statement is just three things: cash in, cash out, and timing—the familiar sources and uses of cash.

Unlike cash flow statements prepared in accordance with generally accepted accounting principles (GAAP), cash flow projections in business plans often begin with sales in units. Showing units and unit prices adds another dimension to a cash flow analysis: The figures for units sold tie in to the projected production schedule (see section 3.6), while the figures for price per unit and volume in units tie in to the break-even analysis (see section 3.7.8). Often only net cash sales are shown, though sometimes the presentation of gross sales and returns (or deductions) and of the resulting net sales may be justified. A sample projected cash flow presentation is shown in Appendix 4. (Also, see the *Accountant's Business Manual Toolkit CD-ROM.*) Note that the periods can be months, quarters, or years.

Preparing cash flow projections usually requires many iterations. Among the important variables or assumptions to test are varying levels of inventory (a notorious cash drain), short-term debt (which increases

the company's risk and vulnerability to recession), and accounts receivable (because bad debt or slow-paying customers can ruin the company). Iterated cash flow projections help determine the ultimate appearance of the other financial statements, the appropriate debt/equity decision for the business, and the percentage of ownership that outsiders should get for their investments.

3.7.8 Other financial analyses

Many business plans include a break-even (or cost/volume) analysis, usually in graph form. Even if break-even figures or graphs are not included in plans intended for outside use, they can be very useful for internal management purposes because they underscore the fact that there are only three possible ways to increase profitability: increase prices, increase volume, and decrease costs (whether fixed or variable). Either break-even sales revenue or break-even unit sales could be provided. Both analyses require assumptions regarding sales volume and prices.

Key financial ratios are sometimes also presented, especially for bank loans. The ratios usually included are:

— Current ratio

— Debt-to-net-worth ratio

— Return on equity

— Gross margin percentage

These ratios are discussed in the chapter on Obtaining Financing.

3.8 Supporting Documents and Exhibits

The supporting documents section of most business plans is somewhat general. It includes any information relevant to the business plan that is not segregated elsewhere. Occasionally, historical financial statements are also put in this section. Organizational charts are sometimes provided, and some business plans place biographies of the lead entrepreneurs or of important owners and managers here. Articles from trade magazines about the industry, product, or service may be relevant to substantiate or corroborate positions presented in the plan. Finally, copies of significant contracts or agreements might also be shown (for example, leases, union agreements, line-of-credit agreements, patents, and licensing agreements). Appendix 5, "Sample Business Plan" illustrates what a completed business plan includes. Appendix 6, "8(a) Business Plan" (see the *Accountant's Business Manual Toolkit CD-ROM*) is a form from the Small Business Administration (SBA) that will assist accountants in helping clients address their business planning needs.

4. FINANCING

This section discusses financing considerations, especially venture capital. The chapter on Obtaining Financing provides an overview of the various sources of debt and equity financing available.

4.1 Debt Versus Equity

The reward an entrepreneur reaps from a business varies tremendously depending on whether debt or equity financing is used. Using all debt is seldom feasible. It is also very risky, because as leverage increases, risk escalates from the ever-increasing drain of cash caused by servicing the debt. If the business fails (the probability of which increases as leverage increases), the entrepreneur often faces personal as well as professional disaster because, typically, the entrepreneur is forced to guarantee the business debt personally.

Alternatively, using all equity is usually equally repugnant to entrepreneurs, because doing so means having to relinquish a significant share of the business—sometimes even majority control.

Leverage affects risk, as do the type and stage of a business venture; all, therefore, affect whether debt or equity financing should be used. In the early stages of a venture, equity financing is often the only choice. As the business grows, establishes a record, and thus appears less risky, debt financing becomes more available and more attractive. The newer and the more untested the company, the greater the risk presented by debt financing.

4.2 Venture Capital

Large growth potential and large capital needs, together with potentially large payoffs (and big risks), are the signs that point to seeking venture capital as a source of funds.[3] Venture capitalists have to see significant potential before they will be interested in a company.

4.2.1 Characteristics of venture capital

Depending on the risk, venture capitalists may require an annual return on investment of from 30 percent to 80 percent. In return for their investment, they usually obtain a significant share of the business—often majority control and always significant influence over decision

[3]This section draws on the excellent discussion of venture capital found in Alleva and Barnes, *Price Waterhouse Review*, 1988, no. 2:42–51.

making. If the business begins to collapse, they may take over daily control or replace management. Finally, although venture capitalists provide long-term capital and are willing to wait from 3 to 10 years for a return on their investment, they want to be able to bail out. Venture capitalists want to be able to liquidate their investments by a sale or merger of the company or else by taking it public through an initial public offering.

Although venture capitalists expect a high return, the degree of risk of the businesses funded by venture capital should always be kept in mind. Even if an entrepreneur must relinquish a major share of the business, it is better to own part of a well-capitalized company that stands a good chance of success than to own 100 percent of a company that will fail or never even get off the ground for lack of capital.

Many venture capital firms specialize in certain industries—for example, computer hardware or software, genetic engineering, or publishing. Some fund only companies in the conceptual stage by providing "seed money," whereas others will not even consider funding a business until it has a track record of a few years.

4.2.2 Pricing of venture capital deals

There are many ways to value a business (see the chapter on Business Valuations herein). A typical venture capital pricing, however, involves the use of price/earnings (P/E) ratios (earnings multiples) and discounted cash flow techniques.

To illustrate, assume that a venture capitalist agrees to invest $1 million in a privately held manufacturing company that expects $3 million net earnings five years from now. The company has 1,000,000 shares of stock outstanding. Similar public companies have P/E ratios of 10, and the same earnings multiples are expected to hold true for the next five years. The venture capitalist requires a 50 percent return on its investment and plans to cash out at the end of the fifth year by taking the company public.

The calculation of the share of the business that goes to the venture capitalist is as follows:

Projected Earnings Per Share (EPS):

$$\frac{\$3 \text{ million projected net earnings in fifth year}}{1 \text{ million shares outstanding}} = \$3 \text{ EPS}$$

Projected Stock Price When Company Goes Public:

$3 EPS × 10 P/E ratio = $30 per share

Projected Value of Company When Company Goes Public:

$30 per share × 1 million shares = $30 million

Present Value of Business:

$$\frac{\$30 \text{ million future value of company}}{(1 + 0.50\%)^5}$$

(1 + 0.50%)	Discount factor (50% return for 5 years)
= $3,950,617	Present value of business

Percentage Ownership Venture Capitalist Gets for $1 Million Invested:

$$= \frac{\$1 \text{ million invested}}{\$3{,}950{,}617 \text{ present value of business}}$$

25% ownership interest

5. THE ACCOUNTANT'S ROLE

An accountant's training and experience provide an overall business sense that few other professionals can match. Financial projections and the related financial analyses make up the inner workings of a business plan. Accountants (whether practicing CPAs or part of financial management in industry) should, therefore, be closely involved in all aspects of business planning.

Especially with start-ups, the immediate concern is raising capital and, based on projected financial statements, showing some evidence that the business will ultimately be able to generate enough operating income to repay creditors and provide a return on investment commensurate with the risk of the venture.

Although most accountants should be able to help project financial statements, many businesses—especially start-ups—need extensive help in targeting how much debt or equity to seek, which creditors or investors to approach, and how to minimize the usually lengthy delay from business-plan completion to obtainment of suitable financing. In part, this means maintaining close relationships with banks, other commercial lenders, large private investors, and a range of venture capital firms.

5.1 Business Planning Engagements and Clients

Business planning clients must usually be sought out. Perhaps the best way to build a business planning practice is to build on existing client relationships: Many of an accountant's existing write-up, audit, and tax clients need business plans, even if they don't know it.

The following situations all suggest the need for formal business planning help that accountants can provide:

— Additional capital for needed growth

— Cash flow difficulties (for example, trouble in paying suppliers, meeting payrolls, or servicing debt)

— Impending bankruptcy

— New competition or changed technology in the industry

— Changes in management

— Calls for help with specific problems that may be symptomatic of bigger problems (for example, chaotic recordkeeping suggests underlying management problems)

— Mergers and acquisitions

Of course, many companies do some sort of budgeting, but few take the added step of formally tying a budget to the company's overall strategic plan for marketing, production and operations, and logistics. For those clients who do budget already, accountants should help them make the leap to incorporating the yearly budget into an annual business plan. For those clients who do not even have a formal budgeting system, the accountant can urge beginning with a formal business plan (which is simply a far more comprehensive budget document) or can suggest that the client start with a one- or two-year budget, then later integrate the budgeting system into a continually updated business plan. A company's tactics—and often even its goals and objectives—need to change. The important thing is to regularly compare actual results with projections and to update and adapt plans accordingly. Sometimes clients can do this themselves, but often accountants can gain valuable ongoing planning engagements by simply being alert to opportunities.

5.1.1 Undertaking a planning engagement

A client may request a consulting engagement for assistance in establishing business goals and developing plans, or the practitioner may recommend it, based on knowledge of the client's operations and need for planning. When a client requests assistance, the practitioner may want to determine whether there are any underlying reasons or special purposes for the request. The practitioner needs to know the pertinent facts to help the client develop goals and plans that are appropriate and well matched to the needs of the organization.

In deciding whether to accept the engagement, the practitioner considers the nature of the client's business and the specific request for service in light of the practitioner's own standards, policies, and capabilities. If the request for services is from a prospective client, the practitioner might ask the following pertinent questions:

— Who referred the prospective client?
— Has the prospective client previously engaged another accountant, and if so, why is a new one being sought?
— Is the prospective client seeking to establish a continuing relationship with the practitioner or asking for one-time-only assistance?
— How long has the client been in business?
— Who are the owners/partners?
— What is the nature of the client's current business?
— What is the financial history of the client's current business?
— Were there any earlier business ventures, and what resulted from them?
— With whom does the client bank?
— What law firm does the client use?

The practitioner may conduct a brief preliminary fact-finding survey to develop an understanding of the client. The most critical factors are the benefits the client anticipates and what the practitioner needs to do to accomplish the engagement objectives. The time devoted to a preliminary survey may be less for an existing client because of the practitioner's familiarity with the client's operations, personnel, and other key factors.

From the information obtained during discussions with the client and from the preliminary fact-finding survey, the practitioner might prepare notes for reaching an oral understanding with the client or might develop a written engagement proposal. If the client accepts the proposal, the practitioner develops an engagement schedule, which establishes target dates or time allocations and the responsibilities of persons involved in the engagement work phases and activities.

5.2 Professional Standards for Business Plans

The close relationship of business planning to other types of professional engagements provided by CPAs makes determining the scope of service important. Understanding the requirements is especially so, because the procedures and reports required by the various professional standards and the resulting fees that must be charged have to be explained to the client in advance. The client must understand and agree to both the ultimate scope and the cost of the engagement.

The preparation or submission of historical financial statements or information in conjunction with business planning engagements

may be subject to the applicable standards from the Public Company Accounting Oversight Board and AICPA. In addition, the *Guide for Prospective Financial Information* applies to all financial forecasts or projections intended for third-party use.

The applicable professional guidance and standards for business planning engagements are discussed in the sections that follow.

5.2.1 Business plans as management consulting services

Developing business plans is a form of management consulting service. The authoritative professional literature on management consulting services is contained in the Statement on Standards for Consulting Services (SSCS) issued by the Management Consulting Services Executive Committee of the AICPA.

Statement on Standards for Consulting Services No. 1, *Definitions and Standards,* requires that MCS consultants be professionally competent and that they exercise due professional care. MCS engagements must be adequately planned and supervised, and sufficient relevant data must be obtained to afford a reasonable basis for conclusions or recommendations.

Among other requirements, SSCS No. 1 requires a CPA who performs a business plan engagement to *reach an understanding with the client.* Although either oral or written understandings are permitted, reducing the understanding to a clear, unequivocal written agreement signed by both parties is the preferable approach.

SSCS No. 1 states that agreements with clients should address:

— Nature of the services

— Scope of engagement, including limitations or constraints

— Roles, responsibilities, and relationships of all parties involved

The following issues may also be made explicit in the agreement for this type of engagement (although not specified in the SSCS):

— Overall approach to the engagement, including major tasks, activities, and methods

— Form and timing of both status reports and the final report

— Work schedule

— Fee arrangement

— Whether historical financial statements will be included in the business plan

— How the client intends to use the business plan (that is, strictly for internal use or for the use of certain contemplated third parties, such as prospective lenders or creditors)

— Whether the accountant's name will be associated with any of the financial information presented (whether historical or prospective)

— Whether specialists will be used (for example, marketing experts)

In discussing fee arrangements, the CPA must take into account all the professional standards that must be met for the engagement and make sure that the client understands the required work, time commitments, and resulting fees.

After completing the engagement, the CPA should provide a report (oral or written, though, again, a written document should virtually always be prepared) on all significant results, assumptions made (see section 3.7.3 herein for a discussion of financial assumptions used in business plans), and any qualifications or reservations the CPA may have.

5.2.2 Historical financial statements and SSARS No. 1

If a business plan includes unaudited historical financial statements of a nonpublic company, SSARS No. 1, *Compilation and Review of Financial Statements,* as amended, sets forth the accountant's responsibility as such:

> An accountant should not consent to the use of his or her name in a document or written communication containing unaudited financial statements of a nonpublic entity unless (a) the accountant has compiled or reviewed the financial statements in compliance with the provisions of this Statement or (b) the financial statements are accompanied by an indication that the accountant has not compiled or reviewed the financial statements and that the accountant assumes no responsibility for them.

SSARS No. 1 makes no exception according to the intended use of the statements—that is, business plans that will be used only internally versus those that will be distributed to certain contemplated third parties. The conclusion to be reached, therefore, is that accountants must always indicate their responsibility for historical financial statements included in a business plan.

One exception that SSARS No. 1 does make applies if only *selected* financial information is included in a business plan. Examples include specified elements of financial statements (such as sales figures) or certain accounts. However, a CPA may attest to such specified elements under the Statement on Standards for Attestation Engagements *Attestation Standards.*

5.2.3 Financial Forecasts and Projections

Chapter 3, "Financial Forecasts and Projections," of Statement on Standards for Attestation Engagements No. 10, *Attestation Standards: Revision*

and Recodification (AT sec. 301), applies only to complete presentations; essentially, this means full basic financial statements of prospective financial information that is intended for use by third parties.

SSAE No. 10 defines *financial forecasts* as the expected, or best, estimate of future financial results. *Financial projection* is a broader term that includes financial forecasts. Projections are "what if . . ." results that assume certain specified hypothetical circumstances or courses of action.

CPAs may be engaged to examine or at least compile financial statements that are intended for third parties (or reasonably expected to be used by third parties). SSAE No. 10 covers situations where the accountant performs agreed-upon procedures on the prospective financial information. The procedures and reports required depend, of course, on the type of engagement: an examination, compilation, or agreed-upon procedures.

5.2.4 Guide for Prospective Financial Statements

Although the AICPA Audit and Accounting Guide *Guide for Prospective Financial Information* does not have the authority of pronouncements enforceable under Rule 202 of the AICPA Code of Professional Conduct, it provides suggestions and recommendations on the preparation and presentation of prospective financial information. A CPA who fails to follow what the guide recommends should be prepared to justify departures from the recommended practice.

Among the many topics covered in the guide are:

— Definitions, types, and uses of prospective financial statements.

— Responsibility for prospective financial statements.

— Preparation and presentation guidelines.

— Types of accountants' services.

— Appropriate procedures, representation letters, engagement letters, and reports for compilations, examinations, and agreed-upon procedures.

— Partial presentations.

6. SUCCESSION PLANNING

Management succession for closely held businesses is a significant challenge for many business owners because it must be planned far well in advance of the owner's retirement. Unless the owner is planning a sale or merger, developing and grooming a suitable successor must begin

years before the owner's retirement. Some owners fail to address the issue because they are so immersed in operating the business that they neglect even such a vital question as who will take over in the event of disability, retirement, or death.

Succession plans often involve a family member, and owners who fail to deal with this issue in a forthright and timely manner can upset the harmony of family and business relationships. Sometimes owners assume that a child or other relative will step right in, even if they have never discussed this possibility with the individual concerned. In planning for succession, some owners may need to consider the interests of key employees who, though not family members, have contributed to the success of the business and expect a managerial role. Other owners may choose a successor but overlook training him or her to operate the business effectively.

6.1 Situations Requiring Succession Planning

The most appropriate strategy to follow in succession planning depends upon the current business situation and the amount of time available before retirement.

— An owner plans to retire but has no successor.

— A designated successor is no longer interested or available.

— A designated successor needs further training to operate the business effectively.

— An owner's retirement plans have changed, creating a need for a new plan.

— A designated successor lacks the financial resources required by the owner and therefore a new plan is needed.

6.2 Understanding the Business Environment

The goals of the owner, the owner's family, key employees, and the business should be clearly understood before developing a succession plan. Particularly in family businesses, the goals of each generation may never be discussed and the owner may simply assume that a son or daughter wants to become a full participant in the business and is capable of doing so. Open communication is critical in family businesses as there are often psychological and emotional issues involved in families working together.

6.2.1 Business valuation

To reach a decision about succession alternatives, the owner may need a valuation of the business. Often business owners have unrealistic expectations for the value of their business. For more information see the chapter on Business Valuations.

6.2.2 Business profitability

During the period of transition the business may need to support two families. Understanding the current profitability of the business and discussing this with the planned successor is essential. Depending on the period the owner continues actively in the business, changes may need to be made in the business structure to make it sufficiently profitable to support two families. The successor may need to supplement the business income with other earnings during the transition to provide adequate cash flow.

6.2.3 Goals of the owner, family, and key employees

The owner should identify the advantages and disadvantages of any specific ideas about succession. The owner should also understand how co-owners or involved family members feel about such ideas. The business may have operated under a formal business plan or buy-sell agreement with co-owners that may specify the buy-out terms. The owner should also consider the timetable for succession and whether management can manage the change.

Family members involved in the business should be evaluated to assess their personal and financial qualifications. The younger family members sometimes lack the experience and training needed to continue the business successfully. If this situation exists, the owner may consider installing a new CEO to provide the needed skills until the designated family member can properly manage and control the business.

Key employees should be interviewed to determine their opinions regarding the current performance and future potential of the company and their outlook on a potential sale or transfer and its impact on them.

6.3 Individual Goals and Concerns

6.3.1 The owner

After many years of focusing a career toward the business, the owner faces many unknown challenges and possibly fears in transitioning leadership of the business he or she might have spent a lifetime developing. Those issues include:

— A loss of business identity, which might include the reputation built up in the industry or community as an expert in a specialized field of knowledge.

— A reluctance to let go of the leadership reins, under the belief that a new CEO is too inexperienced or indecisive to make proper business decisions.

— Fear of retirement boredom, caused from not developing personal interests in hobbies, family, or civic functions during the owner's lifetime.

The owner will also be concerned about financial security and ongoing cash needs during retirement years. The closely held business may be the most significant asset of the owner and its value directly affects the financial lifestyle available in retirement. For that reason, early succession planning helps to maximize business value by developing management and operational systems that can increasingly function independently of the owner as retirement nears. A plan needs to consider that withdrawing the owner's equity at the least income tax cost is essential for maximizing post-retirement cash flow.

6.3.2 The family

The owner of a closely held business typically has children who will not succeed in management of the business. In many cases, one child may be groomed for succession while other children pursue other livelihoods. Dividing the wealth between active and inactive children is a significant concern for both owner and children. An equitable sharing of the owner's wealth does not necessarily result in equal sharing among the children. Operating a family business often involves long hours and other sacrifices that might be rewarded by a greater percentage of the wealth going to the business successor. Communicating this reality with each family member is essential to maintaining harmony.

The family may be plagued by issues that the owner is reluctant to confront, such as addictions or mental illness, that inhibit the owner's willingness to discuss business transition issues. In fact, sibling competition or conflict may make it impossible to select a suitable family member to succeed the owner. An intermediary can assist in opening up communication to resolve such issues. In some families, there are simply no qualified or interested children to step into the business.

6.4 Family Succession Strategies

The most effective method of transferring ownership to a designated family member is to involve all family members in developing and

implementing a definite plan. Any such plan must integrate into the overall estate plan. The plan needs to specify whether the transfer is a sale, gift, or bequest. This is particularly important when the owner wishes to take advantage of the transfer's tax consequences or obtain compensation from the successor. The plan also needs to define the time frame for the transfer, the responsibilities of the parties involved, and the mechanics of the ownership change (for example, stock or title transfers).

6.4.1 Asset transfers

In many cases the uninvolved children may receive non-business assets, such as investments, real estate, or life insurance, so the entire business unit can be transferred to the successor. Quasi-business assets, such as the real estate used by the business, may be transferred to uninvolved children. This allows them to keep a vital connection to the business by leasing property to the active sibling. In such cases, the owner should consider creating long-term leases that prevent disagreements between siblings. Where the business assets are best kept together, life insurance can be used to equalize distributions among the heirs of the owner's estate.

6.4.2 Gifts to family members

Transfers to family members may occur in annual gifts or all at once. To avoid taxable gifts that would reduce the $1 million lifetime annual gift exclusion, gifts must be restricted in value to $11,000 per year. However, spouses may also give consent to gifts and gifts may be made to a son and daughter-in-law to obtain multiple gift tax exclusions in one year. To qualify for the annual exclusion, the gift must be a present interest in the property (such as a remainder interest).

6.4.3 Self-canceling installment note

A self-canceling installment note (SCIN) is a note established at the time the business is sold to family members in which the terms of the note call for its cancellation upon the death of the seller. Provided the business is sold for fair value, the value of the SCIN is not included in the seller's estate for federal estate tax purposes. The seller's life expectancy must exceed the note's term at the time of sale and a premium must be paid, either in terms of a higher interest rate or above-market selling price, in order to meet the estate tax exclusion. A SCIN allows the owner to transfer assets to a greater extent than the gift tax exclusions allow.

6.4.4 Trusts and family limited partnerships

Trusts and partnerships may be used to transfer fractional interests in property. A family limited partnership (FLP) can be used to transfer gifts of larger potential value by claiming valuation discounts for minority ownership and control interests. The FLP terms cannot be so restrictive, however, that the gift exclusion is challenged by the IRS because the limited partners are so severely restricted from enjoying any current benefits of ownership.

6.4.5 Incorporated businesses

For an incorporated business, all children may share in the stock ownership of the business. To retain voting control while gifts are occurring, the owner needs to retain greater than 50 percent of the voting stock. Multiple classes of stock may be used; however, an S corporation may have only one class of stock with respect to distribution and liquidation rights. S corporations may use both voting and nonvoting common stock to accomplish this objective. The owner may redeem his or her majority stock ownership at retirement by selling stock back to the corporation in exchange for cash or notes extending over several years. The redemption qualifies for capital gain reporting on the installment method providing favorable tax consequences.

6.5 Selling to Key Employees

6.5.1 Leveraged buyout

Selling the business to employees who are not family members is similar to selling it to members of the family, except that many of the interpersonal problems unique to family relationships are absent. The employees need to have the financial resources to acquire the business as well as management capabilities. In a leveraged buyout (LBO) the company is sold to employees or others in a transaction financed by debt that is secured by the business assets or stock. Often the buyers are already active in the business and have the same motivations for the business to succeed as the selling owner. Future cash flow of the business is used to service the debt in an LBO.

6.5.2 Employee stock ownership plan

The owner may transfer ownership of the company by adopting an employee stock ownership plan (ESOP). Under this plan, the company each year contributes a portion of earnings to the ESOP to enable it to buy a percentage of the company stock. Issues to consider if contemplating an ESOP include:

— A longer time frame is required to transfer ownership.

— The company's assets and earning power are at risk for repayment of the ESOP debt; default could place the company in bankruptcy.

— Employees generally have the right to sell their stock to the company at its current market value. This could place a strain on the company with aging employees who wish to sell their stock upon retirement.

— An annual appraisal of the fair market value is required.

6.6 Retaining Ownership With Outside Management

As an alternative to ownership transfer, the owner may look to install a new CEO to run the business while the owner keeps rights of ownership. The owner may also wish to create a board of directors to provide leadership and vision for the company. This approach can be particularly useful where a suitable successor is not found or where the owner believes that the value of the company will significantly increase.

An owner may determine that none of the alternatives discussed above is likely to succeed. In that event, two other alternatives are viable: (1) a sale or merger with an outsider, or (2) liquidation. These alternatives are outside the scope of this chapter.

6.7 Develop a Written Plan

An essential part of the succession plan is communication. This is best accomplished through a detailed written plan with milestone dates. The plan should contain specific measurable actions each year until the owner's retirement. A succession plan should contain the following elements:

— The goals and objectives should be reiterated.

— The planning decisions should be communicated.

— An action plan should detail required steps at defined points.

— A contingency plan should be considered to outline the alternative courses of action if the intended succession cannot occur.

— Dates should be established to review, evaluate, and adjust the plan.

The plan should be reevaluated, reviewed and revised annually by all parties to keep everyone informed and working toward the same objectives.

Even the best-laid plans can fail to materialize if unforeseen events occur. The premature death or disability of the owner could unwind a

succession plan before the successor is in place to take over. A major business catastrophe such as a fire, lawsuit, or product safety recall require an immediate reassessment of the plan. Contingency plans may be made to control some of these risks. For example, the untimely death or disability of the owner can be mitigated by life or disability insurance. Contingency plans should also address the best alternative course of action if the identified successor fails to materialize.

Because succession plans have unique tax consequences to each party, it is important that a tax adviser be closely involved in developing this plan. As importantly, an adviser can act as a liaison between the parties (including bankers, attorneys, employees and family members) to monitor the progress toward the ultimate succession and challenge the parties when necessary to meet the milestones of the plan. Appendix 7 is a checklist that takes the business through the process of planning for retirement and business succession (see the *Toolkit CD-ROM*).

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Web Resources:

Bplans.com. Operated by Palo Alto Software, Inc., this Web site contains a large collection of free, sample business plans and information, as well as business planning software. See www.bplans.com.

Business Plan Archive. Operated by the Robert H. Smith School of Business at the University of Maryland, this Web site collects business plans and other documents from the 1990's dot-com era as a learning tool for researchers, business planners, and entrepreneurs. See www.businessplanarchive.org.

Center for Business Planning. This Web site operated by Business Resource Software, Inc., has sample business plans, resource links, and software products for business planning. See www.businessplans.org/index.asp.

Small Business Administration (SBA). This Web site contains topical areas devoted to the small business owner and general business planning concepts, including "Starting Your Business," "Financing Your Business," and "Managing Your Business." The "Library" section contains electronic publications devoted to business planning. See www.sba.gov/library/pubs.html

APPENDIX 1: Sample Business Plan Outline

I. COVER SHEET
II. TABLE OF CONTENTS
III. EXECUTIVE SUMMARY
  A. Product or service
  B. Market
  C. Objectives, strategies, and critical success factors
  D. Funding needed and purpose
  E. Projected financial performance
IV. ORGANIZATION, MANAGEMENT, AND HUMAN RESOURCES
  A. Organization
    1. Description and history
    2. Legal form and tax status
    3. Locations of headquarters, plants, offices
    4. Achievements and problems (both past and foreseen)
    5. Capital (debt or equity) sought and uses planned
    6. Current and planned capital structure
  B. Management and human resources
    1. Short biographies or resumes of key managers and other personnel
    2. Current and proposed number of employees
    3. Compensation and benefits policies
    4. Union affiliations (present or foreseen)
    5. Management and human resources budget
V. OBJECTIVES
  A. Projected returns, plans to go public
  B. Expected use of resources
  C. Timing of expected use
  D. Methods planned
VI. ACTION PLAN
  A. Detailed, specific, and coordinated steps to be taken to meet objectives specified
VII. MARKETING
  A. Product or service
    1. Description (plus broader implications of product or service sold)
    2. Brand names, if applicable, and prices
    3. Patents, trademarks, copyrights, franchises, or licensing agreements
    4. Budget
  B. Market analysis
    1. Target market
    2. Customer preferences and needs

3. Customers versus end users
4. Size, history, and trends market
5. Demographics
6. Market research

C. Industry analysis
1. Critical success factors
2. Projected growth of industry, market, and company
3. Important risks
4. Ease of entry into market
5. Industry patents, trademarks, copyrights, franchises, and licensing agreements
6. Stage and maturity of the market
7. Seasonality
8. Sensitivity to business cycles
9. Government regulation
10. Normal credit policies
11. Advertising and promotion
12. Trends, fads, and importance of innovations and technological changes
13. Price sensitivity analyses and possible substitutions
14. Major competitors
15. Distribution
16. Prevailing sales methods

D. Marketing strategy
1. Attributes of the product or service to be emphasized
2. Pricing policies
3. Distribution channels
4. Service and warranties
5. Credit policies
6. Advertising and promotion
7. Sales personnel or direct-marketing staffing and compensation

VIII. PRODUCTION AND OPERATIONS

A. Description of manufacturing, purchasing (retail), or delivery of services
B. Location, description of plants or offices
C. Capacity and utilization
D. Major cost components (e.g., direct labor versus specific direct material costs)
E. Expansion plans
F. Major fixed assets (current and planned)
G. Make-versus-buy considerations
H. Quality control
I. Changes in production technology and threats from imports

J. Shelf-life, potential obsolescence of inventory
K. Current and expected inventory turnover
L. Discussion of major suppliers
M. Budget

IX. FINANCIAL PRESENTATION AND DATA
A. Feasibility studies
B. Scenarios and time horizons
C. Assumptions
D. Historical financial statements
E. Prospective sales forecasts, cash flow statements, balance sheets, and income statements
F. Other financial analyses (e.g., break-even analyses, financial ratios)

X. SUPPORTING DOCUMENTS AND EXHIBITS
A. Management biographies or resumes (optional)
B. Organizational charts
C. Pictures of product
D. Historical financial statements (optional)
E. Significant contracts or agreements
F. Articles from trade magazines

APPENDIX 2: Sample Format for Financial Statement Projections

BUSINESS PLANS

APPENDIX 2: Sample Format for Financial Statement Projections

Projection of Financial Statements

Submitted By:

#				Actual		Projections	
		Spreadsheet in Hundreds ☐	Date	6/30/99	6/30/00	6/30/01	6/30/02
		Spreadsheet in Thousands ☐	Period	1	2	3	4
1		NET SALES					
2	P	COST OF GOODS SOLD					
3	R	GROSS PROFIT		0	0	0	0
4	O	Less: Sales Expense					
5	F	General & Administrative Expense					
6	I	Depreciation					
7	T	OPERATING PROFIT		0	0	0	0
8	and	Less: Other Expense					
9	L	Add: Other Income					
10	O	Gain/(Loss) on Sale of Fixed Assets					
11	S	PRE TAX PROFIT		0	0	0	0
12	S	Less: Income Tax Provision					
13		NET PROFIT		0	0	0	0
14	MEMO	Inventory Purchases					
15		CASH BALANCE (Opening)			0	0	0
16	C	Add: Cash Sales Plus Receivable Collections					
17	A	Other Income		0	0	0	0
18	S	Bank Loan Proceeds					
19	H	Other Loan Proceeds					
20		Proceeds from Fixed Asset Sales					
21	P	TOTAL CASH AND RECEIPTS		0	0	0	0
22	R	Less Disbursements: Trade Payables					
23	O	Other Expense		0	0	0	0
24	J	Operating Expenses		0	0	0	0
25	E	Capital Expenditures					
26	C	Income Taxes					
27	T	Dividends or Withdrawls					
28	I	Bank Loan Repayments					
29	O	Other Loan Repayments					
30	N	Payment on LTD					
31	S	TOTAL CASH DISBURSEMENTS		0	0	0	0
32		CASH BALANCE (Closing)		0	0	0	0
33		ASSETS Cash & Cash Equivalents		0	0	0	0
34		Receivables			0	0	0
35	B	Inventory (Net)			0	0	0
36	A	CURRENT ASSETS		0	0	0	0
37	L	Fixed Assets (Net)			0	0	0
38	A	TOTAL ASSETS		0	0	0	0
39	N	LIABILITIES Notes Payable Banks			0	0	0
40	C	Notes Payable Others			0	0	0
41	E	Trade Payables			0	0	0
42		Income Tax Payable			0	0	0
43	S	Current Portion L T D			0	0	0
44	H	CURRENT LIABILITIES		0	0	0	0
45	E	Long Term Liabilities			0	0	0
46	E	TOTAL LIABILITIES		0	0	0	0
47	T	NET WORTH Capital Stock			0	0	0
48		Retained Earnings			0	0	0
49		TOTAL LIABILITIES AND NET WORTH		0	0	0	0

BUSINESS PLANS App. 2

HOW TO USE THE FINANCIAL STATEMENT PROJECTION TEMPLATE

The Financial Statements projection is presented as an interactive template and may be completed by the banker, the customer, or both working together. It is designed to be flexible and may be used as a

1) Projection tool to provide a picture of the customer's present and future financial condition. Actual and estimated financial data form the basis of the calculations.
2) Tool for Analysis of the customer's borrowing needs and debt repayment ability.
3) Budget to aid in planning for the customer's financial requirements and repaying the banker's credit accommodation.

INSTRUCTIONS In the first column, enter the actual PROFIT AND LOSS STATEMENT and BALANCE SHEET of the date immediately prior to projection period. Then, in each subsequent column, covering a projection period (e.g. month, quarter, annual).

- Enter on the "date" line, the ending date of each projection period (e.g. 1/31, 3/31, 19____).
- Then follow the line-by-line instructions below.

Line No	Title	Instructions
PROFIT AND LOSS STATEMENT		
1	NET SALES	Enter the actual or beginning net sales figure in the first vertical column. We suggest you project future net sales based upon a % sales increase or decrease. Estimate acceptable % figure and record here _______%. (This % is generally calculated based on historical changes in net sales. However, consideration must also be given to factors, such as general business conditions, net products and services, and competition.)
2	COST OF GOODS SOLD	Enter all relevant components of customer's cost of goods sold calculation. Project future cost of goods sold based upon % increase or decrease. Estimate acceptable percentage figure and insert here _____% (This figure is generally based on an increase or decrease. Estimate acceptable percentage.
3	GROSS PROFIT	Line 1 minus line 2. This field is automatically calculated and protected from overwrite.
4 through 6	Sales Expense, Other Expense, General and Administrative Expense.	Enter all items. Project future expenses based on an increase or decrease. Estimate acceptable percentage figure and insert here ______%. (This figure is generally estimated as a percentage of sales based on prior years. Anticipated increases in major expenses, such as lease, officers' salaries, etc. should also be considered).
7	OPERATING PROFIT	Line 2 minus the sum of lines 4 through 6 (calculated)
8 through 10	Various adjustments to Operating Profit	Enter all items and estimate future adjustments (e.g. rents received, interest earned, gain (loss) on asset disposals, and miscellaneous income).
11	PRE-TAX PROFIT	Line 3 minus the sum of lines 8 through 10 (calculated)
12	Income Tax Provision	Common methods used for calculating Income Tax Provision include the must current year's tax as a % of the Pre-Tax Profit.
13	NET PROFIT	Line 7 minus the sum of lines 8 through 15 (calculated)

MEMORANDUM ENTRY

14	Inventory Purchases	This input is necessary for calculation of inventory and trade payables (line 35 and line 41) in the balance sheet section. If inventory purchase figure is not available, calculate balances based on historic turnover ratios.

CASH PROJECTION CALCULATION

15 CASH BALANCE — Enter opening cash balance. For subsequent periods, the closing cash balance (Line 32) from previous period is automatically carried forward in the template. Or, enter an adjusted amount to reflect a desired cash balance.

16 Receipts — Enter total cash sales plus receivables collection. Receivable collections must be calculated separately This requires an analysis of the customer's sale and collection patterns.

(1) Estimate the portion of each month's sales collected in that month and subsequent months.
(2) From the sale's figure last month and the previous month(s), calculate how much of the existing receivable figure will be collected in the current month.
(3) Deduct the collected receivables balance calculated in (2) above from the month-end balance of accounts receivables.
(4) Add this month's sales figure to the remainder of receivable calculated in (3) above. This figure is the new accounts receivable figure for the end of the current month.

EXAMPLE

Assumptions: Projection calculation - monthly

Monthly net sales	9/30 - $250M
	10/30 - $300M
	11/30 - $150M
Accounts Receivable	
Balance	9/30 - $250M
	10/30 - $367M

The average collection period is 45 days. This means that 66.7% (30 days:45 days) of each month's sales will be collected the following month and the remaining 33.3% in the second month.

To determine receivable collections for November

Accounts Receivable			
Balance	10/30		$367M
Deduct 66% of 10/31 sales		200M	
33% of 9/30 sales		83M	283M
			84M
Add 11/30 sales			150M
Accounts Receivable			
Balance, 11/30			$234M

17	Other Income	Automatically transfers from entry on line 9.
18	Bank Loan Proceeds	Enter actual or projected bank loan proceeds on line 18.
19	Other Loan Proceeds	Enter any other loan proceeds on line 19.
20	Fixed Asset Proceeds	Enter cash amount received for sale of assets during the period on line 20.

21	TOTAL CASH AND RECEIPTS	Sum of line 15 through 20 (calculated)
22 through 30	Disbursements	Enter actual or estimated cash disbursements on these lines. Except, note line 23 and 24, other and operating expenses automatically transfer from the Profit and Loss section - lines 4, 5, and 8.
31	TOTAL DISBURSEMENTS	Sum of lines 22 through 30 (calculated).
32	CASH BALANCE (Closing)	Line 21 minus line 31 (calculated). Note. The closing cash balance on line 32 is automatically entered on line 15 in the next column. However, if the closing cash balance is negative or below the desired opening cash balance, then bank loans (line 18 and 19) may be needed to raise the closing cash balance to zero, or to the desired opening cash balance. The bank loan necessitates planning for repayment (line 28 and 29) in subsequent columns.
<u>BALANCE SHEET</u>		
(33 through 37)	ASSETS	
33	Cash and Equivalents	The closing cash balance (line 32) automatically transfers for all periods.
34	Receivables	Enter actual receivables in the first column, only Spreadsheet automatically projects subsequent amounts using previous receivables figure plus projected net sales (line 1), minus projected cash sales and receivables collections (line 19).
35	Inventory	Enter actual inventory in the first column, only. Spreadsheet projects subsequent periods by adding purchases (line14) to beginning inventory. Then subtracting materials used (line 2) to calculate the ending inventory amount.
36	Current Assets	Sum of line 33 through 35 (calculated).
37	Fixed Assets (Net)	Enter fixed assets in first column. Spreadsheet projects subsequent periods by, adding previous year's fixed asset balance to fixed asset additions (line 25) and loss on sale of fixed assets (line 10). Then, deduct amount received from sale of asset (line 20), any gain on fixed asset sale (line 10) and depreciation expense (line6).
38	TOTAL ASSETS	Sum of lines 33 through 37 (calculated)
(39 through 46)	LIABILITIES	
39	Notes Payable-Banks	Enter first column, only. Spreadsheet projects subsequent periods using prior period balance plus loan proceeds (line 18), less repayments (line 28).
40	Notes Payable-Others	Enter first column, only Spreadsheet projects subsequent periods using prior period balance plus note proceeds (line 19), less repayments (line 29).
41	Trade Payables	Enter first column, only. Spreadsheet projects subsequent periods using prior period balance plus purchases (line 14) less payments (line 22).
42	Income Tax Payable	Enter first column, only. Spreadsheet projects subsequent periods by adding prior period balance to income tax provision (line 12) and deducting income taxes paid (line 26).

43	Current Portion Long-Term Debt	Enter first column, only. Spreadsheet projects subsequent periods current maturities equal to the first column payments. Changes will need to be made to subsequent periods current portion of long term debt, if this assumption is not true.
44	CURRENT LIABILITIES	Sum of lines 46 through 51 (calculated).
45	Long-Term Liabilities	Enter long-term liabilities in first column, only. Spreadsheet projects subsequent periods by addition of the previous period long-term debt (line 45) to current portion (line 43) less loan payments (line 30). Note: Additions to long-term debt have been assumed to be zero, if additions occur adjustments to the template will be necessary.
46	TOTAL LIABILITIES	Sum of lines 39 through 45 (calculated).
(47 through 48)	NET WORTH	
47	Capital Stock	Enter current capital stock figure in first column, only. An increase will occur if capital stock is sold, a decrease will occur if existing stock is repurchased or retired. Spreadsheet assumes no changes to capital stock for subsequent periods.
48	Retained Earnings	Enter first column, only. Spreadsheet will calculate subsequent periods by adding prior period retained earnings to projected net profit (line 13), and deducting dividends or withdrawals (line 27).
49	TOTAL LIABILITIES AND NET WORTH	Sum of lines 46 through 48 (calculated).

NOTE: Additional rows may need to be inserted in the appropriate section of the template to allow for items not included in the example due to space limitations (e.g. other current or non-current assets, stockholder receivables, intangibles, current or long term liabilities, equities, etc.). If rows are inserted in the template, formulas may be affected, therefore, adjustments to formulas within the template will also be necessary.

APPENDIX 3: Business Planning Software

This exhibit lists software that can be used to help assemble business plans.

Adarus® Business Plan, Adarus Software, LLC. Develop a professional business plan quickly and easily with the help of four easy-to-use step-by-step wizards (sales, expense, asset/loan, business plan). The Microsoft Excel add-in and template create financial reports needed for a business plan, such as the cash flow, income, balance sheet, break-even, and financial ratios. A formatted business plan outline (title page, table of contents) is created in Microsoft Word. $65. www.adarus.com/.

Automate Your Business Plan, Linda Pinson. Designed for novices, this is a standalone software program, rather than a set of templates that depends on third-party software for compatibility and support. This software presents a step-by-step planning process that enables the user to organize industry expertise into a working business plan that will attract capital and ensure success. Automate Your Business Plan is now being used in every SBA Business Information Center, Women's Business Development Center, and 1-Stop Capital Shop in the United States. $80. www.business-plan.com/.

BizPlanBuilder, JIAN. This package includes spreadsheet and word-processing documents covering the entire spectrum of business plans. The software uses spreadsheet-based tools, including standalone financial model templates (for start-ups or established companies), investor tracking, proceeds from sale of business, space requirements worksheet, and stock option tracking. Word documents include Application for Business Credit, Articles of Incorporation, Commercial Lease Agreement, Core Practices, Core Values, Due Diligence Checklist, General Partnership Agreement, Independent Contractor Agreement, Invitations to Join Board of Directors/Advisors, Loan Proposal Summary Letter, Trademark Application, Press Release to Announce Your New Company, and Private Offering Cover Disclaimer. $99. www.jian.com/.

Business Plan Manual/Your Plan, My Business Analyst.com. This software package includes professionally written templates already formatted in Word and Excel documents. The narrative description is organized into more than 90 pages of consciously scripted text: compelling headlines, sentences, whole paragraphs, tables, and lists. Sections include Executive Summary, Vision and Mission, Present Situation, Goals, Objectives, Company Overview, Legal Business Description, Management Team, Board of Directors, Strategic Alliances, Product Strategy, Current Product, Research and Development, Production and

Delivery, Market Analysis, Market Definition, Customer Profile, Competition, Risk, Marketing Plan, Sales Strategy, Distribution Channels, Advertising and Promotion, Public Relations, Financial Plan, Assumptions, Financial Statements, Capital Requirements, Exit/Payback Strategy, Conclusion, Supporting Documents, Integrated Financial Spreadsheets and Basic Financials. $189. www.mybusinessanalyst.com/.

Business Plan Master, Versatile Software Solutions, Inc. Available in both standard and professional versions, the software includes template files for Lotus, Excel, Word, WordPerfect, and Works for Windows with online documentation. Also included are some very useful "bonus" files, such as amortization schedules, graphs for charting business growth, personal financial statement, and a nondisclosure form, among others. $44. www.vssi.net/.

Business Plan Pro, Palo Alto Software, Inc. This business plan software package integrates with Marketing Plan Pro and Web Strategy Pro software, without overlap, to create a business plan and a corresponding Internet strategy. Demo available. $99. www.paloalto.com/.

Business Plan Writer, Nova Development Corporation. This package enables entrepreneurs to create high-quality business plans for the purposes of obtaining financing or charting a course for their enterprises. There is no new software to learn with this product because preformatted model text and spreadsheet documents work directly with users' existing word processor and spreadsheet programs. Users replace the existing text in the model text templates with their own words and replace the existing sample data in the prebuilt spreadsheets with their business numbers by following the guidelines embedded in the model business plan and appendices. A comprehensive User's Guide provides further mentoring. $99. www.novadevelopment.com/.

Exl-Plan, Invest-Tech Limited. Included are a range of powerful, easy-to-use shareware packages for preparing, for example, comprehensive financial projections, budgets, and business plans for six months and one, three, five, or seven years ahead. They can also be used as a tool for strategic and corporate planning, business restructuring, financial appraisals, and performance monitoring within almost any size business. Packages incorporate comprehensive facilities and features and are suitable for managers and business people with minimal previous experience of financial or business planning, as well as for experienced planners, accountants, consultants and model builders. Exl-Plan is distributed as shareware and freeware ($0–$289 to register). www.planware.org/.

PlanMagic Business, PlanMagic Corporation. This package features an easy-to-use browser interface, which guides the user through the planning process, product line analysis, detailed marketing, and sales and cash-flow forecasts. All the financial sheets are in an easy-to-use Finance Pro module, which offers automatic calculations, automatic ratios, automated charts, and much more. $84.95. planmagic.com/.

PLANMaker, POWERSolutions for Business. This standalone business planning software features a unique tutorial system to go step-by-step through the entire business planning process. Users can cut and paste from any of the three professionally written sample business plans that are included. These sample business plans can assist in the start-up business planning stages by fine-tuning business concepts and business strategy. Formatting, pagination, and projected fiscal layout are automatic business planning tools incorporated into PLANMaker's business plan software. $129. www.planmaker.com/.

Plan Write for Business, Business Resource Software, Inc. Software contains the knowledge and the tools to help users document a plan including Internet, traditional, product, or service business plans. Not only can users print a polished and complete business plan, the software also allows users to create easily a document ready to be published to the Internet. Plan Write for Business creates the HTML and graphic files as well as a Table of Contents hyper-linked to the business plan. Once the files have been created, the business plan may be placed on a secure Web site. $119. www.businessplansoftware.org/.

Quick Plan 2000, Demand Creation, Inc. A complete industry-specific business plan, this software is available for these industries: Restaurant (full service, limited service, fast food, bakeries, caterers, night clubs, themed, expansions, and franchised), Pizzeria, Specialty Coffee, Salon and Day Spa, Bed and Breakfast, Hotel, Internet Start Up, and other businesses. It provides detailed assumptions about the latest industry trends. $195–$295. www.quickplan.com/.

APPENDIX 4: Sample Cash Flow Statement Format

(All figures except units are in dollars.)

	Period 1	*Period 2*	*Period 3*	*Period 4*	*Period 5*	*Period 6*	*Period 7*	*Period 8*	*Total*
Sources of cash									
Units sold									
Price/unit									
Net sales									
Cash collections on sales									
Stock issued									
Short-term borrowings									
Long-term borrowings									
Other									
Net sources of cash									
Uses of cash									
Units purchased									
Cost/unit									
Cash paid for purchases									
Labor									
Management									
Marketing/sales									
Administration									
Rent and utilities									
Taxes and fees									
Interest expense									
Fixed assets purchased									
Short-term debt repaid									
Long-term debt repaid									
Dividends									
Net uses of cash									
Net cash flow/period									
Cumulative cash flow									

	Period 1	*Period 2*	*Period 3*	*Period 4*	*Period 5*	*Period 6*	*Period 7*	*Period 8*	*Total*
Selected balance sheet accounts									
Beginning balance									
Cash									
Accounts receivable									
Inventory									
Fixed assets									
Total assets									
Accounts payable									
Short-term debt									
Long-term debt									
Equity									
Total liabilities & equity									

Additional data:

Average days in receivables
Average days in payables
Average rate on loans

Also, see *Toolkit CD-ROM* for an Excel worksheet of this form.

APPENDIX 5: Sample Business Plan

MERRILL ENTERPRISES, INC.: New Business Proposal

Table of Contents

Statement of Purpose

Part I. The Business

Business Strategy
Key Objectives, Policies, and Plans
Key Skills and Resources
Management and Personnel
Personal Objectives of Mr. David Merrill
Relevant Industry Trends

Part II. Financial Data

Sources and Applications of Funds
Balance Sheet, P&Ls, and Cash Flow
Breakeven Analysis
Risk Analysis

Part III. Supporting Documents

Personal Resume*
"The Nature of American Broadcasting"*
"FMs Continue to Show Strength in Latest Arbitron Sweep"*
"Cox Study Sees Big FM Growth at AM's Expense"*
"Arbitron Radio Sweep Shows Listening Habits Diversifying"*
Doherty Memo: "Radio and TV Station*
Revenue Trends"*

*These supporting documents have been omitted.

Statement of Purpose

Merrill Enterprises, Inc., is seeking capital of approximately $400,000 to purchase an existing Class B or Class C FM radio station in the United States.

The acquired FM station will have tangible and intangible assets whose market value will be approximately $1 million. Merrill Enterprises will make an equity investment of $10,000, which together with other

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equity and debt financing, will be sufficient cash reserves, and provide adequate working capital to expand an existing market share in listeners and advertising revenues. These funds will finance the transition through an expansion phase which will allow the station to operate as an ongoing, highly profitable business entity.

PART I: THE BUSINESS

Business Strategy

The overall strategy of Merrill Enterprises is to identify and acquire an FM station that has the potential to be a first-class technical facility and does not compete directly with one or more stations owned by the large conglomerates that control a dominant share of the market.

Only stations that satisfy these two conditions will be possible acquisition candidates.[1] The rationale for this acquisition policy is that billings (and ultimately profitability) are a function of listenership and ratings which, in turn, are functions partly of coverage and the ability of a station to be heard relative to its competitors. Consequently, a powerful technical facility is a necessary condition of future growth in any given market.

For various reasons, an acquisition candidate may not have realized its full technical and marketing capability. Merrill Enterprises will identify such stations and the changes required to realize full potential. Upon successful acquisition, Merrill Enterprises will implement these changes.

The market needed to sustain a technically powerful station must be a relatively large one in order to achieve high profitability. However, the particular market cannot be dominated by one (or a few) station(s) with access to substantial capital and managerial resources. Capturing market share from such a competitor will prove to be both difficult and risky as a long-term strategy.

Key Objectives, Policies, and Plans

The key corporate objectives are to acquire and operate an FM station in the second 50's market[2] which has the potential to produce:

1) Sales of approximately $2 million in five years (15 percent growth rate);

[1]The acquisition candidates may also include: 1) stations that have both AM/FM licenses and are being sold as a package; 2) AM stations that have a Construction Permit to establish an FM station.

[2]Market size is determined by ratings of the American Research Bureau, on the basis of net weekly circulation for the most recent year. The selling prices of FM stations in the first 50's markets will be beyond our purchase capability.

2) Operating profits of 50 percent of net revenues within five years of acquisition;
3) Profit before taxes of 15 percent of net revenues within five years of acquisition.

The principal policies are:

1. Acquisition Policy

Only stations with upside potential from technical and marketing changes will be considered. Given available financial resources and future objectives, FM stations with annual billings of approximately $400,000 to $500,000 will be possible candidates. At an industry multiple of 2 to 2½ times sales, the price range will be approximately $800,000 to $1,250,000 for an FM station with these billings.

2. Marketing Policy

Our marketing policy is to identify the market segments and programming which provide the optimum coverage given the geographic scope of our radio signal.

This policy may seem overly general to individuals who are unfamiliar with the radio broadcasting business. Nevertheless, the general nature of this policy is its strength in that it recognizes the unique situations of most radio stations. It is flexible in spirit and recognizes that pat marketing formulas generally do not work when applied "across the board."

3. Technical Facility Policy

Our policy is to create and maintain the best technical FM facility in terms of coverage and ability to be heard relative to local competition. This policy requires the acquisition of a Class B or Class C station.

NOTE: The FCC grants commercial licenses to three types of FM stations. Class A stations are licensed throughout the United States. However, they are low powered with a maximum of 3 Kw of power. Both Class B and Class C stations are licensed in noncompeting sections of the United States and have considerably higher power capabilities which provide them with a competitive edge.

4. Financial Policy

Our principal financial policy is to limit debt financing within acceptable boundaries to provide:

1) Adequate cash flow for operations.
2) Above-average returns for equity investors.

The present market for FM stations is one which requires a buyer to have established lines of equity capital *before* entering negotiations for a specific site. FM stations with potential do not remain long enough on the market; consequently, prospective buyers must be capable of entering meaningful negotiations quickly and from a position of financial strength when an opportunity presents itself.

Key Skills and Resources

A quality broadcasting property is a scarce commodity. One reason they are scarce is because the FCC limits the supply of all broadcasting stations. But within the existing supply of stations, the acquisition of a station with a high-quality potential is also affected by the ability of potential owners to:

1) Find and identify a property with upside potential.
2) Negotiate a sale at a favorable price and terms.
3) Seek FCC licensing approval in an efficient and effective manner.
4) Identify and implement the steps needed to realize the station's full potential.

Merrill Enterprises has the expertise to successfully realize the above requirements. The principal skills possessed by Merrill Enterprises are the skills, capabilities, and experience embodied in its president, Mr. David Merrill.

The track record of Mr. Merrill speaks for itself (see Personal Resume in Section III[3]). He has demonstrated a strong management capability with the special ability to turn marginal FM stations into much improved performers. While he has had numerous successes in his 20-year career in the radio business, his current position as General Manager of one of the top hundred stations in the United States has demonstrated particularly that he can handle even the bleakest of situations and is capable of taking proper and decisive action when required.

Overall, Mr. Merrill brings together several skills not usually found in a single person in the radio broadcast business. He has above-average knowledge of the technical aspects of broadcasting. He is one of the best FM marketing managers in the United States. He has numerous contacts throughout the industry, which will provide a source of acquisition candidates and management technical personnel. He has a working knowledge of FCC regulations and an established relationship with them. He has strong sales and sales management capability. Finally, he has developed the skills needed for general management.

[3]Omitted from this sample plan.

Furthermore, Mr. Merrill is willing to relocate anywhere in the United States where a high-potential FM radio station is discovered and acquired.

Management and Personnel

Mr. Merrill will be president and general manager of the acquired station. Prior to takeover, he will staff the station with the best available personnel.

Personal Objectives of Mr. David Merrill

Mr. Merrill's personal objectives are:

1) To apply his management experience and expertise in the FM radio business.
2) To obtain a majority equity position in an FM radio station in order to fully exercise his capabilities.

Relevant Industry Trends

A number of industry trends are emerging which are relevant to this investment proposal.

These trends include the following:

1) Several sources indicate that:
   a) FM stations have performed well above average as a group, especially those stations employing a "beautiful music" format (see "FMs Continue to Show Strength in Latest Arbitron Sweep." Section III*);
   b) FM stations have achieved their growth at the expense of AM radio stations (see "Cox Study." Section III*);
   c) FM stations have achieved a position of strong positive cash flow which is expected to improve even further by 200X ("Cox Study." Section III*).
2) Market surveys indicate that radio listening habits are becoming more diverse. This trend suggests that creative marketing, including program definition, will become even more critical in the future. (See "Arbitron Sweep Shows Listening Habits Diversifying." Section III*).
3) The expectation is that independent FM stations in the top 125 markets will experience a sales growth of 25% to 30% in 200X. (See "Doherty Memo." Section III*).

Excerpts from an FCC publication, "The Nature of American Broadcasting," present other trends relevant to this proposal. It is included in Section III*.

PART II: FINANCIAL DATA

Sources and Applications of Funds

The likelihood is that the search process for an FM station will uncover two kinds of potential acquisitions.

One kind is the FM station that has a facility with appropriate technical capability in place. The second kind is a station that does not have the appropriate facility but, for example, possesses a construction permit to establish the required plant and equipment. Our assumption is that the asking price for the former facility will be considerably higher than the station requiring incremental capital investment. Consequently, the application of funds will differ for the two different kinds of acquisitions.

Exhibit 1 shows a sources and applications statement assuming no incremental investment in plant and equipment.

Exhibit 2 presents a similar statement assuming additional plant and equipment are required to achieve FM Class B or C status.

Professional and ethical considerations will require Mr. Merrill to inform his present employers that he intends to actively seek an FM station for purchase. He will probably have to relinquish his present position at the time he announces his intentions.

However, Mr. Merrill estimates that it will require between six to twelve months locating, negotiating a purchase, and obtaining FCC approval for the transfer of ownership. During this interim period, Mr. Merrill requires a salary that will allow him to meet his existing financial commitments. This salary is figured at an annual rate of $45,000.

Balance Sheet, P&Ls, and Cash Flow

The following exhibits demonstrate the potential of Merrill Enterprises to generate cash and profits.

Exhibit 3 shows a simple, opening balance sheet.

Exhibits 4 and 5 present a balance sheet and income statement for a potential acquisition XYZ, which is an "average" operation according to industry statistics.

Exhibit 6 shows the effect of acquiring XYZ on the balance sheet of Merrill Enterprises.

Exhibit 7 presents the consequences of retiring XYZ's debt immediately after acquisition.

Exhibits 8–12 provide income statements, cash flows, and balance sheets for Merrill Enterprises after one year of operations.

Exhibit 13 provides a five-year projection of income. One major assumption is that the company attains its five-year goal of reducing operating expenses to 50 percent of sales. A second assumption is that a 25 percent growth in sales is realized in year three from marketing changes instituted by Mr. Merrill during the previous two years.

Exhibit 1
Sources and Applications of Cash
(No Incremental P&E)

Sources		
	Mr. David Merrill	$ 10,000
	Venture Capital	400,000
	Bank Loan	800,000
	Total	$1,210,000
Applications		
	Purchase Stock of Station	$1,050,000
	Working Capital	100,000
	Reserve for Contingencies	15,000
	Pre-purchase salary for Mr. Merrill	45,000
	Total	$1,210,000

Exhibit 2
Sources and Applications of Cash
(Incremental P&E Investment)

Sources		
	Mr. David Merrill	$ 10,000
	Venture Capital	400,000
	Bank Loan	800,000
	Total	$1,210,000
Applications		
	Purchase Stock of Station	$ 800,000
	Plant, Equipment & Renovations	250,000
	Working Capital	100,000
	Reserve for Contingencies	15,000
	Pre-purchase salary for Mr. Merrill	45,000
	Total	$1,210,000

Exhibit 3
Balance Sheet for September 1, 20X1

Assets		**Liabilities and Equity**	
Cash (Equity)	$ 410,000	Long-Term Debt	$ 800,000
Cash (Bank loan)	800,000	Equity	410,000
Total Assets	$1,210,000	Total Liabilities and Equity	$1,210,000

Exhibit 4
Balance Sheet for December 31, 20X1
of Acquisition Company XYZ

Assets		**Liabilities**	
Cash	$ 6,889	Accounts Payable	$ 41,667
Accounts Receivable	76,444	Notes Payable	13,050
Prepaids	2,640	Accrued Expense	14,711
Deferred Reciprocal Expense	9,775	Deferred Reciprocal Revenue	17,322
Total Current	$ 95,748	Total Current	$ 86,750
Net P&E	200,000	Net Long-Term Debt	86,286
Intangible Assets	103,527	Total Equity	226,239
Total Assets	$399,275	Total Liabilities and Equity	$399,275

Notes for Exhibit 4

The figures in Exhibit 4 are derived from the operations of an actual station that is considered a representative example.

Cash—Cash balances are traditionally low in the radio business. The equivalent of about 5.7 days is assumed in this example.

A/R—Projected at about 63 days. 435,000/360 × 63 = 76,444.

Deferred—Reciprocal Expenses and Revenues are trade accounts where radio advertising time is exchanged for goods and services. They are projected conservatively to show a net liability.

P&E—Plant and equipment. Estimated by Mr. Merrill.

Intangible Assets—Estimated from private source.

Accounts Payable—Projected at 35 days based on sales since information was not available for "purchases" nor "cost of goods sold."

Notes Payable—The current portion of long-term debt.

Exhibit 5
Income Statement for December 31, 20X1
of Acquisition Company XYZ

Sales	$435,000	100%
Agency Commissions	52,519	–12
Net Sales	382,481	88
Operating Expenses (includes Depreciation)	304,994	–70
Operating Income	77,487	18
Other Expenses (interest, amortization)	12,487	– 3
Profit before Taxes	65,000	15
Taxes	19,700	– 5
Net Profit	45,300	10
Depreciation	12,900	+ 3
Approximate Cash Flow	58,200	13

Notes for Exhibit 5

Agency commissions, operating expenses, other expenses, taxes, and depreciation in Exhibit 5 are derived from the operations of an actual station that is considered a representative example.

These calculations are supported by the National Association of Broadcasters (NAB) data which show that the average pre-tax profit of FM stations with sales in the $500,000 range is 14–15 percent of sales.

Exhibit 6
Balance Sheet for January 20X2
Merrill Enterprises, Inc.

(Buys Station XYZ for $1,050,000 with net tangible assets of $122,712.)

Cash	$ 160,000	A/P	$ 41,667
Cash	6,889	N/P	13,050
Accounts Receivable	76,444	Accrued Expense	14,711
Prepaids	2,640	Deferred Reciprocal Revenue	17,322
Deferred Reciprocal Revenue	9,775	Total Current	86,750
Total Current	255,748		
P&E	200,000	Long-Term Debt	86,286
		Long-Term Debt	800,000
Intangible Assets	927,288		
		Total Liabilities	973,036
		Equity	410,000
Total Assets	$1,383,036		$1,383,036

Notes for Exhibit 6

Net tangible assets = 122,712 = (from Exhibit 4)
(95,748 + 200,000) − (86,750 + 86,286)

Cash = 160,000 = (1,210,000 − 1,050,000) + 6,889 from cash account of acquired company.

All other current assets and liabilities from acquisition company.

P&E = Plant and equipment subtracted from Exhibit 4

Intangible assets = difference between selling price (1,050,000) and net tangible assets (122,712) allocated to specific intangible with fixed life.

Exhibit 7
Balance Sheet for January 2, 20X2
Merrill Enterprises, Inc.

Given excess working capital position, assume Note Payable and respective long-term debts are retired immediately.

Cash	$ 67,553	A/P	$ 41,667
A/R	76,444	Accrued Expense	14,711
Prepaids	2,640		
Deferred Reciprocal Expense	9,775	Deferred Reciprocal Revenue	17,322
Total Current	156,412	Total Current	73,700
P&E	200,000	Long-Term Debt	800,000
Intangible Assets	927,288	Equity	410,000
Total Assets	$1,283,700		$1,283,700

Notes for Exhibit 7

Cash balance of $166,889 reduced by 13,050 + 86,286 to $67,553.

Exhibit 8
Income Statement for December 31, 20X2
Merrill Enterprises

Sales (15% growth assumed)	$500	100%
Agency Commissions	60	12
Net Sales	440	88
Depreciation	20	4
Operating Expenses	305	61
Operating Income	115	23
Interest	45	9
Amortization	45	9
Pre-Tax Profit	25	5
Tax	4	1
Profit After Tax	21	4
Depreciation & Amortization	65	13
Cash Flow	86	17

Notes for Exhibit 8

This pro forma is actually quite conservative since it reflects no significant reduction of costs which Mr. Merrill states is usually possible when taking over most FM properties. For instance, it is not unusual to find a station that is overstaffed. Still, we have projected operating expenses plus depreciation at 65 percent of sales. At the pre-acquisition sales level of $435,000, this is equivalent to 75 percent of sales. ($325,000/435,000). Even under these conservative conditions, a profit after tax is realized plus a cash flow equivalent roughly to a 20 percent return on equity.

Exhibit 9
Cash Flow for 12 Months Ending December 31, 20X2
Merrill Enterprises

Sales	$500,000
Cash Inflows:	
Collection of January 1, 20X2 A/R	76,444
Cash Receipts from 20X2 sales (45-day lag)	437,500
Total Cash Inflows	513,944
Cash Outflows:	
Operating Expenses	305,000
Debt Service (interest only required)	45,000
Commissions (12 percent of sales)	60,000
Income Tax Estimates	4,000
Total Cash Outflows	414,000
Net Cash Flow	$ 99,944

Exhibit 10
Changes in Balance Sheet Derived from 12 Months P&L and Cash Flow Statements

Cash	+	$99,944	Acct's Pay. plug — 1956	
Acc'ts Rec.	–	13,944	Accrued + 1956 held at 12 days	
Plant & Equip.	–	20,000	Deferred Reciprocal Revenue —no change	
Intangible Assets	–	45,000	Long-Term Debt & Equity — no change	
Prepaids & Deferred Reciprocal Expense		0	Retained Earnings + $21,000	
Total		$21,000	Total	+$21,000

Notes for Exhibit 10

Cash is derived from net cash flow of Exhibit 9 which is slightly higher but more accurate than rough cash flow shown in Exhibit 8.

Accounts Receivable is also derived from Exhibit 9 (sales $500,000 – cash receipts of $437,500 – $76,444 January 1, 20X2 A/R).

Plant and equipment is depreciated straight-line over ten years ($200,000/10) – $20,000.

Intangible Assets are amortized over 20 years. Actual figure is $46,364, but this was rounded to $45,000.

No change was assumed for prepaids, deferred reciprocal expenses and revenues, long-term debt, equity.

For conservatism, accrued expenses were held at a rate equivalent to 12 days of sales over 360-day year.

Exhibit 11
Balance Sheet for December 31, 20X2
Merrill Enterprises

Cash	$ 167,497	Accounts Payable	$ 39,711
Accounts Receivable	62,500	Accrued Expense	16,667
Prepaids	2,640		
Deferred Reciprocal Expense	9,775	Deferred Reciprocal Revenue	17,322
Total Current	242,412	Total Current	73,700
Plant & Equipment	180,000	Long-Term Debt	800,000
Intangible Assets	882,288	Equity	410,000
		Retained Earnings	21,000
	$1,304,700		$1,304,700

Exhibit 12
Balance Sheet for January 1, 20X3
Merrill Enterprises

Cash Position Reduced to Retire 1/8th of Long-Term Debt and Make Dividend Payment to Preferred Stockholders

Cash	$ 48,497	Accounts Payable	$ 39,711
Accounts Receivable	62,500	Accrued Expense	16,667
Prepaids	2,640		
Deferred Reciprocal Expense	9,775	Deferred Reciprocal Revenue	17,322
Total Current	123,412	Total Current	73,700
Plant & Equipment	180,000	Long-Term Debt	700,000
Intangible Assets	882,288	Equity	412,000
Total Assets	$1,185,700		$1,185,700

Notes for Exhibit 12

Cash accounts reduced to adjust for principal payment of long-term debt ($100,000) and dividend payment ($19,000). Acid test or liquidity ratio still about 1:0.

Exhibit 13
Five-Year Income Projection

Growth Rate:	15%	15%	25%	15%	15%
End of Year:	1	2	3	4	5
Sales	500	575	719	827	951
Agency Commissions	60	69	86	99	114
Net Sales	440	506	633	728	837
Expenses					
Depreciation	20	20	20	20	20
Other Operating*	305	334	395	430	475
Operating Income	115	152	218	278	342
Other Expenses					
Interest	45	45	45	45	45
Amortization	45	45	45	45	45
Profit Pre-Tax	25	62	128	188	252
Taxes	6	18	50	79	109
Net Profit	19	44	78	109	143
Depre. & Amort.	65	65	65	65	65
Cash Flow	84	109	143	174	208
*As a % of Sales	61%	58%	55%	52%	50%

Breakeven Analysis

Radio broadcasting is a relatively high fixed-cost business. The only variable cost element that changes month-to-month with sales is commissions. These commissions include payments to agency and internal sales personnel.

Consequently, the basic cost structure of the business is:

Sales	=	100%
Variable Costs	=	27%
Contribution		73%

Using a contribution margin of 73 percent, we can calculate the sales (profit) breakeven and the cash breakeven.

As noted in Exhibit 8, the percentage of agency commissions to total sales is 12 percent. The difference between 12 percent and 27 percent (total variable costs) represents commissions paid to representatives and manager overrides. This 15 percent amounts to $75,000, which is included in operating expenses of Exhibit 8. Once removed, total fixed costs are:

$$\$340{,}000 = (\$305{,}000 - 75{,}000) + 20{,}000 + 45{,}000 + 45{,}000$$

Consequently, "profit" breakeven is:

$$\$466{,}000 = \frac{\$340{,}000}{.73}$$

By removing non-cash expenses (depreciation and amortization of intangible assets), a "cash" breakeven can be calculated as:

$$\$377{,}000 = \frac{\$340{,}000 - 20{,}000 - 45{,}000}{.73}$$

These breakevens represent, respectively, 93 percent and 75 percent of gross sales.

Risk Analysis

Compared to most new venture investments, the risks associated with the proposed venture are considerably lower.

One reason for this lower risk is that the product (FM broadcasting) is a known and successful medium. Also, FM and FM/AM combinations appear to be entering the growth phase of their product life cycles and supplanting the more mature AM radio broadcasting.

A second reason for lower risk is that the entrepreneur in question is deeply familiar with the proposed business. He has direct management experience with the product, as opposed to someone with a new product but no experience managing a business built around the product.

A third reason is that the proposal calls for the acquisition of an ongoing business, as opposed to a startup. This will maximize Mr. Merrill's strengths as quickly as possible.

Fourth, a minimum amount of capital will be exposed before an FCC licensing decision is reached. The sum in question is approximately $20,000 to $25,000 for Mr. Merrill's salary during this interim period. Also, the estimated probability of denial is extremely low given the FCC's goals.

IRS Practice and Procedure

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SUGGESTED REFERENCES

RESOURCE: Where to Obtain Out-of-State Tax Forms (*see Toolkit CD-ROM*)

APPENDIX 1: Recognition and Authorization Requirements for Persons Appearing Before the IRS (*see Toolkit CD-ROM*)

APPENDIX 2: Record Retention (*see Toolkit CD-ROM*)

APPENDIX 3: Sample Circular 230 Disclosure Statements (*see Toolkit CD-ROM*)

APPENDIX 4: Covered Opinions (*see Toolkit CD-ROM*)

1. MISSION AND ORGANIZATION OF THE INTERNAL REVENUE SERVICE

The Internal Revenue Service (IRS) is a branch of the Treasury Department. The commissioner of the IRS is the top official. From the national office in Washington, D.C., the commissioner oversees operations and sets policy.

The IRS Restructuring and Reform Act of 1998 (the 1998 Act) revised the three-tier structure of national, regional, and district offices. The new focus is on four operating divisions, namely, (1) Wage and Investment (W&I); (2) Small Business/Self Employed (SB/SE); (3) Large and Mid-Size Business (LMSB); and (4) Tax Exempt and Government Entities (TE/GE). Other divisions include appeals, communications, and criminal investigation. The most significant part of the 1998 Act, however, was twofold. First, it created an IRS Oversight Board with nine members, six of whom are referred to as "private life" members who are otherwise neither federal officers nor employees. This nine-member board will oversee the IRS, particularly its law enforcement and collection procedures—two IRS activities that the U.S. Senate found to be problem-prone. Second, steps have been taken to reinforce the independence of the appeals function within the IRS, particularly by placing limitations on communications between appeals officers and other IRS employers during the pendancy of an appeal.

The office of the chief counsel of the IRS is a division of the Treasury Department. Legal counsel are located in each region. Many district offices also have legal counsel. One of the tasks of the counsel's office is to resolve the taxpayer's administrative appeals.

Tax examiners, also called office auditors, conduct their examinations within the IRS office, by correspondence, or by office appointment. Revenue agents handle field examinations at a tax practitioner's or taxpayer's place of business. Revenue officers are agents of the collection division. Special agents handle criminal investigations.

2. PRACTICE BEFORE THE IRS

Treasury Department Circular 230, Practice Before the Internal Revenue Service, covers all matters connected with a presentation to the IRS or any of its officers or employees relating to a client's rights, privileges, or liabilities under laws or regulations administered by the IRS. Such presentations include preparing and filing necessary documents, corresponding and communicating with the IRS, and representing a client at conferences, hearings, and meetings. A return includes an amended return and a claim for refund.

This means that any person may prepare a tax return for himself or herself or for any other person. If that return is audited, the preparer, without further credentials or qualification, may appear to explain the return and represent the taxpayer before tax examiners, revenue agents, or other examining officers of the district audit division. Authorization from the taxpayer is required. Authorization should be indicated on Form 2848. Tax return preparers who are not CPAs, attorneys, enrolled agents, or actuaries cannot represent the taxpayer at any level of proceedings beyond the examination level, even if they hold the taxpayer's power of attorney. They cannot, for example, appear before the appeals division. They cannot execute documents that limit or bind the taxpayer's rights of action, such as waivers of time limits, consents to immediate assessment of tax, or closing agreements assenting to a deficiency.

The IRS assigns a centralized authorization file number (CAF) to each person granted "representative authority." The centralized file indicates the extent of a representative's authority. A tax preparer who is assigned more than one CAF should choose one of the numbers to use exclusively in subsequent communications with the IRS.

Tax return preparers are assigned a unique number that must be indicated on every return or correspondence (IRC Sec. 6109 and Treas. Reg. Sec. 1.6109-2).

Appendix 1, "Recognition and Authorization Requirements for Persons Appearing Before the IRS," on *The Accountant's Business Manual Toolkit CD-ROM,* summarizes requirements for appearing before the IRS.

2.1 Persons Authorized to Practice Before the IRS

Corporations may be represented by their officers, partnerships by their partners, and estates or trusts by their fiduciaries.

Treasury Department Circular 230 (hereafter called Circular 230) explains who has the right to practice before the IRS and specifies standards of conduct. This circular is available at most local IRS offices or through the toll-free "forms" number listed in most telephone directories and can be downloaded from the IRS Web site (www.irs.gov).

2.1.1 Attorneys

Any attorney not currently under suspension or disbarment may practice before the IRS provided that a written document, stating that the attorney is currently admitted as an attorney, and a power of attorney (Form 2848), signed by the taxpayer and the attorney, are filed with the IRS.

This written document should fully specify the addresses and identification numbers of the attorney and the taxpayer. In addition, attorneys can gain limited authority to receive and inspect tax information from the IRS by filing an authorization and declaration (Form 8821) that has been signed by the client and the attorney. Attorneys must, however, apply to the Tax Court and other federal courts and be admitted to them before representing clients in those courts.

2.1.2 CPAs

Certified public accountants not currently under suspension may practice before the IRS provided that Form 2848 has been filed with the IRS. CPAs may not, however, perform any activity that constitutes the practice of law, including most aspects of tax litigation such as the filing of a petition or pleading with any court. A CPA may be admitted to practice before the Tax Court, as may any person, by passing an examination on court procedures.

2.1.3 Enrolled agents

Any person, even though he or she is not an attorney or CPA, may seek to pass an IRS examination on technical aspects of taxation, thus gaining the right to be designated an enrolled agent or person. Enrolled agents may represent taxpayers to the same extent as CPAs. They may not practice law, nor may they practice before the Tax Court. The examination for enrollment is given in September. Application for the September exam must be made on Form 2587 by August 15. A sample examination is in IRS Publication 693.

Former IRS employees who were engaged in applying and interpreting tax matters for a minimum of five years may apply to become enrolled agents by filing a Form 23 within three years of leaving the IRS (no examination is necessary).

Regulations require enrolled agents to complete continuing education courses prior to renewal of their enrollment. (Bar associations and state licensing boards now require continuing education of CPAs and attorneys.)

2.1.4 Enrolled actuaries

Actuaries enrolled by the Joint Board for the Enrollment of Actuaries pursuant to 29 U.S.C. 1242 are limited to issues involving, in general, aspects of retirement plans.

2.1.5 Limited practice

Any person whose presence is determined to be necessary to explain facts may appear before the IRS as a witness.

2.1.6 Authorizations and powers of attorney

IRS employees are required to verify the authority of any person who seeks access to a taxpayer's records or who wishes in any manner to represent a taxpayer. The extent of this authority should be indicated by the taxpayer on IRS Form 2848, which may be filed by FAX. IRS Form 8821 can be used to authorize disclosure of information. If the taxpayer's authorization is on file, IRS employees are told to extend the "courtesy of having all arrangements in furtherance of the matter" made through the representative. Additionally, the representative has a right to be present when the client is interviewed and to receive copies of all written communication from the IRS (Internal Revenue Manual Sec. 4055). The taxpayer must also be present at an IRS interview if required to do so by an IRS summons.

Form 8821 authorizes another person to inspect in an IRS office or to receive by mail all tax information, notices, or other written communication related to a specifically identified tax matter. No authority to represent the taxpayer is granted. A newly filed information authorization revokes one previously filed concerning the same tax matters.

IRS Form 2848 (power of attorney and declaration of representative) can be used to grant to a representative the power to

- — Inspect and receive tax information, notices, and communications.
- — Receive (but not negotiate) the taxpayer's refund check.
- — Sign a tax return, in certain cases, on behalf of the taxpayer (Regs. Sec. 1.6012-1(a)(5)).
- — Execute waivers and offers of waivers of restrictions on assessment or collection of deficiencies in tax, or waivers of notice of disallowance of a claim for refund or credit.
- — Execute consents extending the statute of limitations.
- — Execute a closing argument (IRC Sec. 7121).
- — Delegate authority or substitute another representative, if expressly authorized to do so by the taxpayer.

Form 2848 may be executed on behalf of the taxpayer by an attorney-in-fact designated as such in a non-IRS document such as a general, limited, or durable power of attorney.

According to a report by the Cincinnati IRS Service Center, the most common reasons for IRS rejection of a power of attorney are

- — Lack of signature of representative or failure to indicate status, such as CPA, attorney, or enrolled agent.
- — Failure to provide all necessary information required by Form 2848.

— Failure to include the title of a person signing for a business.

— Tax period not clearly identified.

— Omitting EIN or SSN for the taxpayer.

2.1.7 Privileged communications

The attorney-client privilege is extended to provide confidentiality between a taxpayer-client and any individual authorized to practice before the IRS. The privilege applies in noncriminal proceedings before the IRS and in federal courts if the IRS is a party. Certain communications relating to tax shelters are not included in this privilege.

2.2 Persons Who May Not Practice Before the IRS

According to Circular 230, officers and employees of the United States in the executive, legislative, or judicial branch of the government may practice before the IRS only to represent a member of the person's immediate family or any other person or estate for which the person serves as guardian, executor, administrator, trustee, or other personal fiduciary (18 U.S.C. 205). No member of Congress or resident commissioner (elect or serving) may practice in connection with any matter for which he or she directly or indirectly receives, agrees to receive, or seeks any compensation. Officers and employees of any state or subdivision whose jobs entail passing upon, investigation of, or dealing with tax matters of their state or subdivision may not practice if their employment may disclose facts or information applicable to federal tax matters.

2.3 Rules Governing Conduct

2.3.1 Circular 230

Rules of practice before the IRS are spelled out in Circular 230. Disreputable acts or violations of regulations may lead to suspension or disbarment. Such acts include but are not limited to the following:

— Conviction of any criminal offense

— Giving false or misleading information

— False advertising or other impermissible forms of solicitation of clients

— Unreasonably delaying the prompt disposition of any matter before the IRS

— Willfully failing to make a federal tax return
— Misappropriation of, or failure to properly and promptly remit funds received from a client for the purpose of payment of taxes or other obligations due the United States
— Disbarment or suspension of his or her professional license
— Aiding or abetting another person to practice before the IRS who is not properly qualified to do so
— Contemptuous conduct in connection with practice before the IRS (Circular 230; Subpart C)
— Conviction of any offense involving dishonesty or breach of trust
— Charging an unconscionable fee
— Charging a contingent fee for preparing an original return

Circular 230 and the Treasury regulations issued in connection with Circular 230 were substantially revised in December 2004 and January 2005 to provide additional rules governing opinion letters written by tax practitioners. In addition, Section 822(a)(1) of the American Jobs Creation Act of 2004 provides for censure and monetary penalties for tax practitioners who fail to comply with the provisions of Circular 230. See Section 15 of this chapter.

2.3.2 AICPA tax standards

Statements on Standards for Tax Services (SSTSs) No. 1 through 8 and Interpretation No. 1-1, "Realistic Possibility Standard," of SSTS No. 1, reflect the AICPA's standards of tax practice and delineate members' responsibilities to taxpayers, the public, the government, and the profession. The Statements are intended to be part of an ongoing process that may require changes to and interpretations of current SSTSs in recognition of the accelerating rate of change in tax laws and the continued importance of tax practice to members.

The Tax Executive Committee interprets AICPA general professional standards and promulgates technical standards in the tax area, by authority of the AICPA Council. Enforcement of these rules is undertaken as part of the AICPA's Code of Professional Conduct Rule 201, *General Standards,* and Rule 202, *Compliance with Standards.* Members are expected to comply with them.

SSTSs Nos. 1 through 8 and Interpretation No. 1-1 can be downloaded from www.aicpa.org as a portable document format (PDF) file (*Note:* The Adobe Acrobat Reader is needed to view a file in PDF format). The SSTSs can be downloaded at www.aicpa.org/download/tax/SSTSfinal.pdf and are current as of August 2000.

The SSTSs are also available for purchase in pamphlet form at www.CPA2Biz.com.

2.3.3 AICPA Code of Professional Conduct

Contingent Fees. Rule 302 of the Code of Professional Conduct of the AICPA states that

> A member in public practice shall not prepare an original or amended tax return or claim for a tax refund for a contingent fee for any client.

Contingent fees are fees established for the performance of any service within an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such service.

Fees are not regarded as contingent if they are fixed by courts or other public authorities, or, in tax matters, if the fees are determined based on the result of judicial proceedings or on the findings of governmental agencies.

A fee is considered to be "determined based on the findings of governmental agencies" if the member can demonstrate a reasonable expectation at the time of a fee arrangement of substantive consideration by an agency with respect to the member's client. Such an expectation is not reasonable in the case of preparation of original tax returns.

Examples of Contingent-Fee Situations. The following are examples, not all-inclusive, of circumstances where a contingent fee would be permitted.

— Representing a client in an examination by a revenue agent of the client's federal or state income tax return.

— Filing an amended federal or state income tax return claiming a tax refund based on a tax issue that is either the subject of a test case (involving a different taxpayer) or with respect to which the taxing authority is developing a position.

— Filing an amended federal or state income tax return (or refund claim) claiming a tax refund in an amount greater than the threshold for review by the Joint Committee on Internal Revenue Taxation (currently $2,000,000) or state taxing authority.

— Requesting a refund of either overpayments of interest or penalties charged to a client's account or deposits of taxes improperly accounted for by the federal or state taxing authority in circumstances where the taxing authority has established procedures for the substantive review of such refund requests.

— Requesting, by means of "protest" or similar document, consideration by the state or local taxing authority of a reduction in the "assessed value" of property under an established taxing authority

review process for hearing all taxpayer arguments relating to assessed value.

— Representing a client in connection with obtaining a private letter ruling or influencing the drafting of a regulation or statute.

The following is an example of a circumstance where a contingent fee would not be permitted:

— Preparing an amended federal or state income tax return for a client claiming a refund of taxes because a deduction was inadvertently omitted from the return originally filed. There is no question as to the propriety of the deduction; rather the claim is filed to correct an omission.

On February 3, 2006, the IRS proposed broad restrictions on contingent fees. The proposed rules would allow contingent fees only for services in connection with IRS audits or challenges of an original tax return. These restrictions create a potential concern for AICPA members, therefore AICPA has taken a leading role in responding to these proposed rules. For instance, in a June 2006 hearing regarding on REG 122380-02, AICPA was granted a request to testify on behalf of members and REG 122380-02 proposals are still up for discussion by the AICPA.

Discreditable Acts. Rule 501 of the AICPA's Code of Professional Conduct states that a member shall not commit an act discreditable to the profession. Disciplinary actions under this rule have been taken against AICPA members in connection with income tax violations. For example, a practitioner was given a ninety-day membership suspension for assisting a client in preparing a return that included an improper depreciation deduction related to a tax shelter.

Disciplinary Actions by the AICPA, State Boards of Accountancy, and State CPA Societies. The Bylaws of the AICPA provide for a professional ethics division and for a trial board to hear charges of violations of the bylaws or of the Code of Professional Conduct. Disciplinary actions against members are reported in the *CPA Letter,* the semimonthly newsletter of the AICPA. A membership can be suspended without a hearing, and then terminated upon final conviction, for any of these offenses:

— A crime punishable by imprisonment for more than one year

— The willful failure to file any income tax return that the member, as an individual taxpayer, is required by law to file

— The filing of a false or fraudulent income tax return on the member's or a client's behalf

— The willful aiding in the preparation and presentation of a false and fraudulent income tax return of a client (AICPA Bylaws 7.3.1)

2.3.4 Conduct of IRS employees

The IRS must terminate an employee (absent direct intervention by the IRS Commissioner as explained below) if there is a final administrative or judicial determination that, in the course of his or her official duties, the employee committed any of the following acts:

1. Willfully failed to obtain the required approval signatures on documents authorizing the seizure of a taxpayer's home, personal belongings, or business assets
2. Provided a false statement under oath with respect to a material matter involving a taxpayer or a taxpayer representative
3. Violated the rights of a taxpayer, taxpayer representative, or other employee of the IRS under the U.S. Constitution or under specified civil rights acts

(Text continued on page 13)

4. Falsified or destroyed documents to conceal mistakes made by any employee with regard to a matter involving a taxpayer or taxpayer representative
5. Assaulted or battered a taxpayer, taxpayer representative, or other employee of the IRS, but only if there is a criminal conviction or a final civil judgment to that effect
6. Violated the 1986 IRC, Treasury regulations, or IRS policies (including the IRS Manual) for the purpose of retaliating against or harassing a taxpayer or other employee of the IRS
7. Willfully misused the provisions of IRC Sec. 6103 (regarding confidentiality of returns and return information) for the purpose of concealing information from congressional inquiry
8. Willfully failed to file any tax return required under the IRC on or before the required date, unless the failure is due to reasonable cause and not willful neglect
9. Willfully understated federal tax liability, unless such understatement is due to reasonable cause and not willful neglect
10. Threatened to audit a taxpayer for the purpose of extracting personal gain or benefit

2.4 Tax Preparer's Liability

2.4.1 Definition of "tax return preparer"

The term *tax return preparer* (TRP) applies to any person who prepares for compensation, or who employs one or more persons to prepare for compensation, any return of tax or claim for refund of tax. Income tax return preparers must manually sign the returns they prepare and must include their name and identification number. To be classified as a TRP a person must prepare all or a substantial portion of the return, but the person does not have to be the one physically to enter the figures on the form or schedule, nor does entering these figures automatically make a person a TRP (IRC Sec. 7701). Anyone may be held to be a TRP (even if he or she does not sign the return) who

— Provides advice that reduces filling out a return to a mere clerical task.

— Provides tax advice about completed transactions directly relating to a specific entry on a return.

— Recommends substantial changes in a draft of a return (even if the draft was prepared by the taxpayer) and the taxpayer follows the recommendations.

— Reviews the return, concludes no changes are required, and mails in the return under the taxpayer's instructions.

— Makes entries on one return—for example, a partnership return—that constitute a substantial portion of a partner's return, thus becoming a TRP with regard to both the partnership and the partner's return.

Example: An attorney who prepared Forms 1065 for three limited partnerships was held also to be a preparer of the tax returns of the limited partners themselves. (*Randall S. Goulding v. U.S.,* 92-1 USTC 50,174 (7th Cir., 1992), aff'g D.C. 89-1 USTC 9309.)

On the other hand, merely typing or photocopying the return does not make one a preparer, and neither does preparing a return

— For an employer, officer of the employer, or for a fellow employee, or for one or more general partners in a partnership in which the preparer is a general partner or an employee.

— As a fiduciary.

— For a friend, relative, or neighbor with no agreement for compensation (either stated or implicit), even though a favor or gift is received in return.

If more than one person worked on a return (or claim for refund), a determination of who is the preparer will be made according to rules of substantial preparation.

2.4.2 Substantial preparation

Each schedule, entry, or portion of a return or claim for refund is reviewed separately to determine who is the preparer. One who renders advice concerning the existence, characterization, or amount of a schedule or entry is subject to IRS regulation as an income tax preparer for that return, including the penalties to which preparers are subject, if the item is a substantial portion of the return. It is not necessary that the person signed the return.

There is a quantitative test to determine when a schedule, entry, or portion of a return is substantial: An item is not substantial if it is less than $2,000, or is less than $100,000 while also less than 20 percent of adjusted gross income (Treas. Reg. 301.7701-15).

2.4.3 What constitutes an income tax return

Preparer penalties relate only to the preparation of certain specified forms that constitute tax returns (Treas. Reg. 301.7701-15(c)):

— Individual or corporate income tax return

— Fiduciary income tax return for an estate or trust

— Undistributed capital gains tax return for a regulated investment company
— Charitable remainder trust return
— Return for a transferor of stock or securities to a foreign entity
— S corporation return
— Partnership return for a Domestic International Sales Corporation (DISC)
— Refund claim for a credit against any income tax
— Information return on behalf of a person or entity that is not a taxable entity but reports information that may be reported on the return of a taxpayer.

On the other hand, these are not "tax returns" for purposes of determining preparer penalties:

— Gift or estate tax return
— Returns for excise tax or tax collected at the source on wages
— Individual or corporate declaration of estimated tax
— Application for an extension of time to file an individual or corporate return
— An informational statement on Form 990, Form 1099, or a similar form

2.4.4 Potential penalties facing preparers

Penalties on preparers of $50 per instance ($25,000 maximum per year) may be assessed under various subsections of IRC Sec. 6695 for failure to

— Furnish a copy of the return or refund claim to the taxpayer.
— Sign a return or claim when required to do so.
— Include the preparer's identifying number.
— Retain for three years copies of all returns and refund claims or a list of taxpayers, identification numbers, and type of filing.
— File an annual information return reporting names of employees who prepare returns for other than the employer.

Certain offenses carry significantly larger penalties:

— Negotiating or endorsing taxpayer refund checks: $500 (IRC 6695(f))

— Assisting in organizing a tax shelter, or making a false or fraudulent or a gross valuation overstatement: $1,000 (IRC 6700)

— Aiding and abetting an understatement of tax liability in connection with a corporation: $10,000; other returns or claims: $1,000 (IRC Sec. 6701)

— An understatement of tax liability due to a position (of which the preparer knew or should have known), for which there was not a realistic possibility of being sustained on its merits and not disclosed as provided in IRC Sec. 6662(d) or the position was frivolous: $250 (IRC 6694(a)) (Discussed more fully in section 2.5)

— An understatement of tax liability due to a willful attempt to understate liability by a preparer or a reckless or intentional disregard of rules or regulations: $1,000 (IRC Sec. 6694(b))

— Disclosing or using information received in connection with the preparation of a return: $250 (IRC Sec. 6713)

— Willfully failing, while acting as a "responsible person," to collect or pay over any tax: penalty is the amount of the tax (IRC Sec. 6672)

In addition to the items on this list, a preparer might be charged with a related crime, for which a jail sentence could be imposed, for example, disclosure or use of tax return information: $1,000 fine or imprisonment not more than one year (IRC Sec. 7216).

Generally, a TRP may rely on information supplied by the taxpayer client. Only when the information appears incorrect, inconsistent, or incomplete must inquiries be made. In one instance a preparer had to pay a penalty when he knew that in a prior year a similar deduction had been attempted but denied upon audit, even though that prior return had been prepared by another.

If the law requires specific conditions in order for a deduction to be properly claimed, a TRP must inquire about the conditions. For example, if travel and entertainment expenses, or business use of a listed asset, are claimed, the TRP should ask if the taxpayer has the records to substantiate the deduction. The preparer may accept the taxpayer's affirmative answer and need not examine the records. Neither is it necessary, under law, for the preparer to examine information returns the taxpayer has received, such as Forms 1099, but many preparers feel it is prudent to do so.

TRPs paid penalties in the following instances:

— The alternative minimum tax was overlooked by a TRP who admitted no knowledge of its existence.

— Through negligence, the amount of a net operating loss was overstated when carried back to prior years. Penalties were paid for each prior year.

— A net operating loss carryforward was mistakenly and negligently overstated, causing penalties to the TRP involved in the calculation.

— The TRP allowed a client to claim five dependents while knowing the client had only two.

— The TRP ignored a bookkeeper's comment that shareholders' personal expenses had been paid from corporate funds.

2.4.5 Recordkeeping

Preparers, or their employers, must retain for a three-year period following the close of the return period a record of the name, Social Security number, and place of work of each employed preparer. (The return period is defined as a twelve-month period beginning on July 1 of each year.) These records must be made available for inspection by the district director. The penalty is $50 for each failure to retain and make available a record, plus a $50 penalty for each missing but required item. The maximum penalty for any return period is $25,000 (IRC Sec. 6695). Appendix 2, "Record Retention," of this chapter, on *The Accountant's Business Manual Toolkit CD-ROM* includes guidelines on recordkeeping for clients.

2.4.6 Procedures for assessing penalties

The IRS must assess a penalty within three years after the improperly handled return. There are no limitations if willful understatement of tax liability has occurred. Computer-generated account information called PINEX (Penalty and Interest Notice Explanation) is available from IRS service centers and district offices.

The IRS issues a thirty-day letter as notification of a proposed penalty. The burden of proof is on the preparer as to whether he or she intentionally or willfully disregarded rules or regulations. The IRS bears the burden of proof concerning the preparer's willful attempt to understate tax liability.

If a penalty for understatement of tax is assessed (and the preparer either does not pursue an administrative remedy or receives an adverse administrative determination), the preparer has two alternatives:

— Pay the amount assessed and file a claim for refund.

— Pay 15 percent of the amount assessed within thirty days of the demand for payment and file a claim for refund of the amount paid within the same thirty-day period.

2.4.7 Injunctions against preparers

Injunctions are sometimes sought by the IRS in federal district court to prohibit improper conduct by a preparer. Penalties may or may not have already been assessed. Violations related to the following activities may be the basis for the injunction:

— Conduct subject to disclosure requirement penalties

— Conduct subject to the understatement of tax liability penalties

— Conduct subject to criminal penalties under the Internal Revenue Code

— Misrepresentation of eligibility to practice before the IRS

— Misrepresentation of experience or education as a tax preparer

— Guaranteeing payment of a tax refund or allowance of a credit

— Engaging in other fraudulent or deceptive conduct that interferes with administration of the tax laws

2.5 Understatement Penalties

IRC Sec. 6694 penalizes a preparer if there is an understatement of liability due to a tax position if there was no realistic possibility of the position being sustained on its merits *and* the position was not properly disclosed *or* if the position was properly disclosed but was frivolous. (Circular 230 defines *frivolous* as patently improper.) According to Circular 230 a preparer may not advise a client to take a tax position, nor himself or herself prepare the portion of the return on which the position is taken unless

— The preparer determines that the position satisfies the realistic possibility standard; or

— The position is not frivolous and the preparer advises the client of (1) any opportunity to avoid the accuracy-related penalty of IRC Sec. 6662 by adequately disclosing the position and (2) the requirements for adequate disclosure.

> *Example 1:* A new statute is unclear on whether a transaction that a taxpayer has engaged in will result in favorable tax treatment. Prior law, however, supported the taxpayer's position. There are no Treasury regulations under the new statute and no authority other than the statutory language and the committee reports. The committee reports state that the intent was not to adversely affect transactions similar to the taxpayer's transaction. *Result:* The taxpayer's position satisfies the realistic possibility standard.

Example 2: A taxpayer has engaged in a transaction that is adversely affected by a new statutory provision. The preparer believes that the new law is inequitable as applied to the taxpayer's situation. The statutory language is unambiguous as it applies to the transaction (for example, it applies to all manufacturers and the taxpayer is a manufacturer). The committee reports do not specifically address the taxpayer's situation. *Result:* A position contrary to the statute does not satisfy the realistic possibility standard.

The section 6694(a) penalty will not be imposed on a preparer if the position taken is not frivolous and is adequately disclosed. (Reg. Sec. 1.6694-2(c)) A "frivolous" position is one that is patently improper. Further, the penalty will not be imposed if, considering all the facts and circumstances, it's determined that the understatement was due to reasonable cause and that the preparer acted in good faith. (Reg. Sec. 1.6694-2(d))

A preparer also must advise his or her client of penalties reasonably likely to apply to a tax position that has been advised, prepared, or reported by the preparer. The preparer must inform the client of opportunities of avoiding these penalties by disclosure and of the means for disclosure. The advice recommended in this paragraph must be given even if the preparer is not subject to a penalty as a consequence of the tax position.

The following are situations in which no additional disclosure need be made.

1. Schedule A, Itemized Deductions:
   a. Medical and Dental Expenses, lines 1-4.
   b. Taxes, lines 5-9. Line 8 must list each type of tax and the amount paid.
   c. Interest Expense, lines 10-14. Not applicable to (i) disallowed investment interest unless Form 4952 is completed, or (ii) amounts disallowed under IRC Sec. 265 (i.e., interest related to tax-exempt income).
   d. Contributions, lines 15-18. Not applicable to (i) donations where the taxpayer receives a substantial benefit, (ii) noncash contributions in excess of $500 unless Form 8283 is attached, or (iii) any contribution of $250 or more unless contemporaneous written substantiation is obtained.
   e. Casualty and Theft Losses, line 19. Form 4684 listing each item for which a loss is claimed must be attached to the return.
2. Certain Trade or Business Expenses:
   a. Casualty and Theft Losses. Same as item 1(e) above.
   b. Legal Expenses. Amount must be stated and cannot be a capital, personal, or nondeductible lobbying or political expenditure.

c. Specific Bad Debt Charge-off. Amount written off must be stated.
d. Repair Expenses. Amount claimed must be stated and cannot be characterized as a capital or personal expenditure.
e. Taxes (other than foreign taxes). Amount claimed must be stated.

3. Other Items:
a. Moving Expenses. Form 3903 or 3903-F must be attached to the return.
b. Sale or Exchange of Main Home. Form 2119 must be attached to the return.
c. Employee Business Expenses. Form 2106 or 2106 EZ must be attached to the return. Does not apply to club dues or travel expenses for any non-employee accompanying the taxpayer.
d. Fuels Credit. Form 4136 must be attached to the return.
e. Investment Credit. Form 3468 must be attached to the return.

An employer (or partnership) can be assessed penalties for *participation* in the negligent, intentional, willful conduct of the person who is technically considered to be the preparer (Regs. Sec. 1.6694-1(a)(1)). A penalty connected with understatement of a taxpayer's liability is not imposed on an employer solely because he or she employs a preparer who becomes subject to penalty. The penalty applies to an employer who knows the employee is understating tax and does not attempt to prevent it (IRC Sec. 6701(c)). Congressional comments suggest negligence might be attributed to a supervisor or reviewer who had responsibility for determining that rules and regulations were being followed but failed to do so. (S. Rep. No. 938, Pt. 1, 94th Cong., 2d Sess. 355 (1976).)

If any part of the understatement of tax liability (or overstatement of a claim for refund) is due to a willful attempt by a tax preparer to understate liability or to the preparer's willful or intentional disregard of tax provisions, the penalty is $1,000 for each return or claim (IRC Sec. 6694(b)(1),(2)). A preparer who received but then ignored information furnished by the taxpayer or by others might be held liable for this penalty.

2.5.1 Effect of understatement of tax liability

If there is no understatement, there can be no penalty. The IRS does not attempt to assert a penalty if there is no more than a relatively immaterial understatement (Revenue Procedure 80-40, 1980 CB 774). No penalty for understatement applies if a final determination of the tax indicates there is no understatement, and any penalties that have been collected will be refunded.

2.5.2 Multiple penalties

In certain cases a preparer may create multiple opportunities for penalty. A negligent claim of a net operating loss in one year may create an understatement of tax liability in each of the carryover years. An understatement on a partnership return that flowed through to be a substantial portion of many limited partners' returns could subject the preparer of the partnership returns to understatement penalties on each of the limited partners' returns.

2.5.3 Negligent disregard for rules and regulations

Guidelines have been issued by the IRS as to what constitutes "negligence" in the context of the former version of IRC Sec. 6694(a). Congressional committee reports indicate that conduct previously considered to be negligent should continue to be penalized after 1989. The relevant definition is this: *Negligence* refers to a lack of due care or a failure to do what a reasonable and prudent person would do under the circumstances (Rev. Proc. 80-4 1980-2 CB 774); (*Brockhouse v. U. S.*, 749 F.2d 1248 (7th Cir. 1984)). The revenue procedure cited states the IRS considers the nature, frequency, and materiality of errors when determining if negligence has occurred. These factors need to be considered by preparers seeking to avoid negligence penalties:

— Negligence does not result where the code section is so complex or highly technical that a competent TRP might misapply it.

— Isolated clerical or mathematical errors are not negligence, but the failure to detect conspicuous examples of these does constitute negligence.

— Ignorance or oversight of a rule or regulation does constitute negligence.

— Information supplied by the taxpayer may be relied upon by a preparer unless it appears incorrect, incomplete, or contradictory.

2.5.4 Normal business practices

The IRS does not assert a negligence penalty if the preparer's *normal business practices* indicate the error would rarely occur and these practices were followed in preparing the faulty return (Treas. Reg. 1.6694-1(a)(5)). Repeated errors of the same type, or a pattern of errors, indicate negligence. Revenue Procedure 80-40 (1980-2 CB 774, 775) cites the following as desirable office practices:

— Worksheets to accumulate data from the taxpayer

— Checklists to indicate returns and schedules suggested by the information
— Review of prior two years' returns
— Supervision of preparation by experienced persons and establishment of means for researching difficult questions
— Review procedures for completed returns
— Sign-off sheets to indicate compliance with prescribed office procedures

2.5.5 Substantial authority

Tax return positions for which the taxpayer has substantial authority are treated as if properly shown on the return, and no substantial understatement penalty is asserted against a preparer. The Omnibus Budget Reconciliation Act of 1989 expanded upon the list of authorities in Regs. Sec. 1.6661-3(b)(2) upon which a taxpayer may rely. The complete list of authorities includes

— Internal Revenue Code and other statutory provisions.
— Temporary and final regulations.
— Court cases.
— Administrative pronouncements (including revenue rulings and revenue procedures).
— Tax treaties and regulations thereunder and Treasury Department explanations of treaties.
— Congressional intent as reflected in committee reports, joint explanatory statements of managers included in conference committee reports, and floor statements made prior to enactment by one of the bill's managers.
— Proposed regulations.
— Private letter rulings.
— Technical advice memoranda.
— Actions on decisions.
— General counsel memoranda.
— Information releases or press releases, notices, and any other similar documents published by the IRS in the Internal Revenue Bulletin.
— General explanations of tax legislation prepared by the Joint Committee on Taxation (called the "Blue Book").

Additionally, the 1989 Omnibus Budget Reconciliation Act required the IRS to publish, not less frequently than annually, a list of tax return positions for which the IRS believes there is no substantial authority and which affect a significant number of taxpayers. The purpose of this list is to assist taxpayers in determining whether a position should be disclosed to avoid the penalties for substantial understatement provided in IRC Sec. 6662(d). Thus, a taxpayer might choose to disclose having taken a position enumerated on the list in order to avoid imposition of the substantial understatement penalty. Disclosure of a tax return position should be on Form 8275-R.

Note that many of the penalty provisions of the Code were modified by the American Jobs Creation Act of 2004 with respect to tax shelters (see section 13.4).

3. IRS PROCEDURE FOR EXAMINING RETURNS

3.1 Initial Review and Screening

The review process begins with routine checks for obvious errors, such as mathematical mistakes and omissions of signatures and Social Security numbers, for all returns filed. These procedures constitute only a cursory review and fall far short of an audit. An audit, also referred to as an examination, may require the taxpayer to respond to questions or to provide supporting data or documentation for elements of his or her tax return. Because of the large volume of returns filed each year, the IRS cannot possibly audit every return filed; less than 1 percent of all returns are audited (but the IRS is working to increase this number). To ensure that IRS audit time is expended productively, the IRS uses several techniques for selecting which returns to audit.

Economic reality audits, also called financial status audits, are permitted only if there exists a prior, reasonable indication of likelihood of unreported income. IRC Sec. 7602(e). Such audits proceeded through the use of questions probing the taxpayer's lifestyle, such as, "Where do you go on vacation?" and "What cars do you own?"

3.2 Selection for Audit

3.2.1 Discriminant Function System (DIF)

After the initial checks, information about individual returns is stored on magnetic tape and sent to the national computer center in Martinsburg, West Virginia. Here the information is processed by computers

and rated for potential errors by a selection program known as the Discriminate Function System (DIF). DIF is a statistical system that assigns numerical values to various items on the return and then produces a composite score for each return. The formulas for developing the DIF score are kept secret from the public. The standards used in developing these formulas are based on the results of examinations from previous years, particularly the results of the TCMP program (see section 3.2.3, which follows). If the composite score indicates that a reasonable chance for error exists in a return, the return can usually be treated by correspondence from an IRS service center. Returns with scores indicating a greater possibility of error are considered for possible office or field examinations.

3.2.2 Manual identification

If a return is singled out by DIF or by other means, experienced IRS auditors apply what can be called a "sniff" test. Various aspects of the return are considered, including the taxpayer's occupation and amounts and types of deductions claimed.

3.2.3 National Research Program (NRP)

The Taxpayer Compliance Measurement Program (TCMP) has been replaced by a National Research Program (NRP). Under this program, the IRS will perform a series of examinations to measure reporting compliance and identify compliance issues. The NRP will focus on the following areas of tax administration compliance:

— Filing
— Payment
— Reporting

3.2.4 IRS instructions to classifiers and auditors

IRS instructions are contained in the *Internal Revenue Manual* (IRM). The Internal Revenue Manual is available on the IRS Web site at: www.irs.gov/irm/index.html. Excerpts from the manual are also available from commercial publishers. Reviewers and auditors are told to consider

— Comparative size of an item in relation to income and other expenses.
— Evidence of intent to mislead, such as missing or incomplete information.
— Beneficial effect of the manner of reporting—for example, expenses are recorded on a business schedule rather than treated as an itemized deduction.

— Relationships such as lack of dividend income while there are sales of securities.
— Characteristics of the business as revealed in the IRS's Market Segments Specialization Program (see section 5.4).

3.3 Chances of Selection

The chance that a return will be selected for audit is determined by several factors, among which is total positive income (TPI). TPI is the sum of all positive income values appearing on a return. Higher amounts of TPI increase a taxpayer's chance of being selected for audit. In recent years, the probability of audit has ranged from 1 to 4 percent for Form 1040 filers, depending on the level of TPI.

Corporations having assets of $1 million or less face a 3 percent or less chance of selections. For corporations with assets over $100 million, the audit percentage is greater than 50 percent.

3.4 Items That May Trigger an Audit

While the actual items that may cause the computer or an examiner to flag a return for audit are not in the public record, there is general agreement among accountants that the following situations tend to increase the chance of audit:

— Deduction for items not clearly authorized by law
— Medical and insurance deductions with, however, no insurance reimbursements
— Large casualty-loss deductions
— Large noncash contributions, particularly when out of proportion with the taxpayer's income
— Large deductions for travel and entertainment expenses not consistent with the nature of the taxpayer's business
— Large interest expense in relation to amount of income reported
— Standard deduction used with high gross and low net income
— Occupations normally more lucrative than indicated by the return
— Return on an investment significantly lower than expected
— Taxpayer's occupation known for its opportunity for receiving income in cash
— Taxpayer under investigation by the Bureau of Narcotics
— Amended returns claiming large refunds in connection with tax shelters.

3.5 How to Reduce the Likelihood of an Audit

The following may reduce the likelihood of an audit:

— Attach all correct W-2 forms. Your client should be instructed to check W-2s as closely as possible and immediately request a corrected W-2 if an error appears.

— Report as a separate identifiable item every Form 1099, even if several come from the same payor.

— If the client requests a replacement for an incorrect Form 1099, but it has not been received by the filing date, report the incorrect amount, then deduct it, report the proper amount and state that a corrected Form 1099 has been requested. Use the same procedure for a Form 1099 for which the payor reports income in the wrong year.

— Be sure the payor's name on the return is identical to the name on the Form 1099.

— Show detail of computations of significant items that might be questioned, such as calculation of basis of an asset.

— Explain allocations between personal and business use such as might appear between Schedule C and Schedule A.

3.6 Safeguards During an Audit (IRC Sec. 7520)

Either before or at the initial interview with the taxpayer, the IRS must provide an explanation of the audit process and the taxpayer's rights, and an explanation of the collection process and the taxpayer's rights, if the interview relates to collection.

At any time during an interview (other than an interview initiated by an administrative summons), the taxpayer can terminate the interview by clearly stating to the IRS a desire to consult with an attorney, CPA, enrolled agent, enrolled actuary, or other authorized representative. The IRS has reaffirmed that taxpayers do not have to answer "economic reality" questions such as types of automobiles owned and the frequency and cost of vacations.

An authorized representative with a written Power of Attorney executed by a taxpayer can represent the taxpayer at an audit. The taxpayer is not required to accompany the representative, unless an administrative summons has been issued to the taxpayer. The IRS can

notify the taxpayer that the representative is responsible for unreasonable delay or hindrance of the IRS examination.

If requested to do so in advance, the IRS must allow the taxpayer to make an audio recording of an in-person interview. The audio recording must be made at the taxpayer's own expense and with the taxpayer's own equipment.

The IRS itself may record an in-person interview if

— The taxpayer is informed prior to the interview.

— The IRS provides the taxpayer with a transcript or copy of the recording upon the request (and cost) of the taxpayer.

Regulations are to provide that it is generally not reasonable for the IRS to require a taxpayer to attend an examination at an IRS office other than the office located closest to the taxpayer's home. Regulations also are to be written to specify that it is generally not reasonable for the IRS to audit a taxpayer at his or her place of business if the business is so small that doing so essentially requires the taxpayer to close the business. The IRS would still be able to go to the place of business to establish facts that require a direct visit, such as inventory and asset verification.

3.7 Advance Warning of an Audit

An entry labeled "examination indicator" in the taxpayer's individual master file sometimes can give warning of an impending audit. See also section 8.2.4 of this chapter.

4. TYPES OF EXAMINATIONS

4.1 Examinations In or From an IRS Office

4.1.1 Correspondence examination

Examination is by correspondence when information concerning questionable items can be readily furnished by mail. Examples of items a taxpayer might be asked to verify by mail include

— Interest.

— Taxes.

— Charitable contributions.

— Medical and dental expenses.

From the taxpayer's point of view, drawbacks to a correspondence audit are said to be that the IRS examiner cannot hear oral arguments and cannot judge the sincerity of the taxpayer. Also, the examiner has the opportunity to review documents at his or her convenience, thus providing time to formulate other questions. On the other hand, in a face-to-face meeting, the agent can initiate a new line of questioning if it appears warranted.

Taxpayers believing the matter cannot be settled satisfactorily by correspondence can request an appointment. If a notice setting up an appointment for an office interview is received, a written request—together with documents supporting the taxpayer's position—can be made that the audit be handled by correspondence.

4.1.2 Office examination

The IRS may request that the taxpayer appear in an IRS office to discuss and provide documentation for matters such as the following:

- Income from tips, pensions, annuities, rents, royalties
- Determination of gain or loss as capital or ordinary income
- Deductions for employee business expenses
- Determination of the basis of property
- Bad-debt deductions
- Questions regarding low income in comparison to exemptions and deductions

The scope of an office examination is normally limited to the items listed on the appointment letter. If necessary to do so, the examiner can be reminded that the taxpayer came prepared to support only those matters listed in the letter.

4.2 Field Examinations

For the majority of business returns, and for some large and complex individual returns, the predominant type of audit is the field audit. The examination usually takes place at the taxpayer's place of business. The revenue agent has full license to examine all books, records, and documents necessary to determine the accuracy of the return. No items on the return are shielded from inquiry. Federal payroll returns and excise tax returns may be examined at the same time. Often all open (unaudited) years of corporation returns as well as the personal returns of officers are audited. Field audits can take several days or weeks. In some cases, it may be possible, by written request, to change the audit

location to the office of the taxpayer's authorized representative, if books and records are maintained there or are transferred there for purposes of the audit.

4.3 Team Examinations

In the case of large corporations, a team of revenue agents may be permanently assigned to examine the tax returns and supporting documentation.

4.4 Select Employee Plans Return Examination (SEPRE)

SEPRE is an investigation for determining if problems exist in the returns of tax-exempt organizations. Tax-exempt organizations are supervised by the employee plans and exempt organization division of the district office to make sure that organizations adhere to the conditions of their tax-exempt status.

4.5 Repetitive Examinations

It has been policy in recent years for the IRS to reduce the incidence of repetitive examinations. This policy is now codified in the Taxpayer Bill of Rights. The IRS will not conduct an examination on an item if there were no changes involving the item during the examinations of the two preceding years, it is unlikely that a change will be made for the year in question, and no significant issues were overlooked during previous years. The agent responsible for the examination may not have access to the returns of the two preceding years, in which case the taxpayer should bring the facts to the agent's attention.

4.6 Audits of Partnerships

4.6.1 Consistency of treatment of partnership items

The tax treatment of partnership items is determined at the partnership level in a unified partnership proceeding. Special rules provide for notice and other types of participation by the individual partners. All entities required to file returns as partnerships are handled under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) rules, with the exception of partnerships with

— Ten or fewer partners who are either natural persons (but not nonresident aliens) or estates (husband and wife are considered one partner for this purpose).
— Each partner's share of any partnership item being the same as his or her distributive share of every other partnership item.

If one of these small partnerships so desires, it can elect to be governed by the TEFRA provisions. TEFRA requires that all partners treat partnership items as they were treated on the partnership return. In an attempt to reduce inconsistencies, the IRS requires that a copy of the information in the partnership return be given to each partner. A partner who decides to treat a partnership item in a way inconsistent with the partnership return must disclose the inconsistency to the IRS on Form 8082. A partner's return should also make a disclosure if the partnership (1) fails to file a return or (2) provides the partner with incorrect information. If an inconsistency in reporting—for example, attempting to expense the partner's share of an item that was capitalized on the partnership return without the partner's filing a notice of inconsistent treatment—leads to a deficiency in tax payment, the IRS makes an adjustment to the partner's return so that it is in conformance with the treatment on the partnership return. Any additional tax resulting from this adjustment is immediately assessed and collected as though it were a mathematical error—that is, without the issuance of a notice of deficiency to the partner. At that point the partner's recourse is to file a claim for refund and sue in U.S. Claims Court. Any underpayment due to inconsistency in reporting, coupled with the taxpayer's failure to file Form 8082, will be treated as intentional or negligent disregard of the rules and regulations and therefore will be subject to penalty.

4.6.2 Partnership audit procedures

To commence an audit of a partnership, the IRS issues a notice of commencement of an administrative proceeding. This notice is sent to every partner. Audits of partnerships impact all partners, but one specific partner, called the tax matters partner (TMP), should be designated by the partnership to be its primary representative. If a TMP is not selected by the partnership, the IRS will choose the partner with the largest profit interest in the tax year in question (in case two or more partners have the same profit interest, the TMP will be chosen alphabetically). Within thirty days of selecting a TMP the IRS must notify all partners entitled to receive notice under IRC Sec. 6223(a) of the selected TMP's name and address. Partners entitled to receive notice are those whose names appear on the partnership returns as well as those whose names and addresses have been timely furnished to the

IRS. The TMP is responsible for keeping all partners informed of the proceedings of the audit and has sole authority to seek judicial review of an audit adjustment. IRC Section 6231(a)(7) defines a tax matters partner.

Any partner entitled to notice is known as a notice partner. No partner can be a notice partner unless the IRS has received name, address, and indication of interest in profits at least thirty days before it mails a notice to the TMP. The term "notice partner" does not include partners with less than a 1 percent interest in partnerships consisting of more than 100 partners. In these partnerships, notice to the TMP is considered to be notice to each partner. Any group of partners having together a 5 percent or greater interest in profits, however, may designate one of their group as a notice partner.

4.6.3 Notices to partners

The IRS must mail notices to every notice partner as well as to the TMP when it begins the audit proceedings. At the conclusion of the audit, a notice of final partnership administrative adjustments (FPAA) is mailed to the notice partners. The notice of the start of the proceeding must be mailed to the other partners no later than 120 days before the notice of the final adjustment is mailed to the TMP. In other words, there must be a lapse of 120 days between these two events. Notice of the FPAA may be mailed to the other partners no later than sixty days after this notice is mailed to the TMP. If, when any notice is mailed, it is too late for a notice partner to join in any judicial proceeding, this partner, while not joining in the proceeding, may still elect to have any decision or agreement apply to him or her and the group the partner represents. Otherwise, partnership items affected in the proceeding are, to that partner, treated as nonpartnership items. If an item is treated as a nonpartnership item, determination of its treatment at the partnership level is not applicable. Nonpartnership items may not be brought into issue by the IRS or by the partner in a partnership proceeding, and partnership items may not be raised in a nonpartnership-item proceeding. Items become nonpartnership items on the date

— The IRS enters into a settlement agreement with the partner.

— The IRS fails to make a timely mailing to a partner concerning a partnership proceeding.

— The partner files suit after the IRS has denied his or her request.

— The IRS notifies a partner that a partnership item is to be treated as a nonpartnership item.

4.6.4 Participation by a partner in an administrative proceeding

Any partner may choose to participate in a proceeding relating to the tax treatment of a partnership item. A settlement agreement between the IRS and one or more partners is binding on the parties to that agreement for the taxable year. Any other partner may obtain the same treatment by requesting it before the expiration of 150 days after the day the FPAA is mailed to the TMP.

4.6.5 Agreements binding on partners

If the TMP enters into a settlement agreement, all partners except notice partners (and members of a 5 percent group who have designated from their group a notice partner) are bound by the agreement. Any partner not wishing to be bound may file a statement with the IRS stating that the TMP does not have authority to enter into such a settlement agreement in this partner's behalf. The time for filing this statement is to be determined by the commissioner.

4.6.6 Provision of judicial review

Once notice of an FPAA is mailed to the TMP, ninety days are allowed to petition for a redetermination. The petition may be addressed to the Tax Court, the U.S. district court, or the U.S. Claims Court. Except for the Tax Court, petitions require that the additional tax due be paid to the commissioner. Any notice partner, upon failure of the TMP to do so within the prescribed ninety-day period, may file the petition and has sixty additional days to do so. The first petition filed takes precedence over all such petitions, and the later ones will be dismissed.

4.6.7 Computational adjustments

Adjustments of mathematical or clerical errors can be corrected by the IRS as partnership items, thus affecting the partners, without applying the usual deficiency procedures. Within sixty days after such a correction notice is mailed to him or her, however, a partner may request that the IRS not make the correction.

4.6.8 Credits or refunds

A partner may not file suit for a credit or refund arising out of a partnership item without first filing a request for administrative adjustment (RAA). The RAA must be filed within three years after the later of the date of actual filing of the partnership return or the last day prescribed for filing the return without regard to extensions. The RAA

must be filed before IRS notice of an FPAA. If the RAA is not fully allowed, the TMP may file a petition for adjustment of the disallowance with the tax, district, or claims court. This petition must be filed after expiration of six months from the filing of the RAA but within two years of the filing. See IRC Section 6227(c) for rules regarding filings of RAA by partners on their own behalf.

4.6.9 Limitation periods for assessments and refund claims

Assessments relating to a partnership item

- — May not be filed before close of the 150th day after mailing to the TMP notice of an FPAA.
- — May not be filed until completion of proceedings in Tax Court (if begun within the 150-day period).
- — Must be made within three years following the later of the date of actual filing or the last day prescribed for filing of a partnership return (unless extended by the commissioner).
- — May be made within six years if a false return has been filed.
- — May be made within six years if partnership income that exceeded 25 percent of stated gross income was omitted.

For refund claims or claims for credit, the time limitations are generally the same as for assessments. When an RAA is timely filed, however, the period with respect to such a request does not expire until the period has expired for filing suit.

4.7 Audits of S Corporations

New audit procedures were created by the Subchapter S Revision Act of 1982. The intent is to follow the partnership model (see section 4.6) in a unified corporate proceeding. Each shareholder must be given notice and an opportunity to participate in administrative or judicial proceedings. Shareholders must treat corporate items consistently with their treatment on the S corporation's return. Rules relating to assessments, limitation periods, and appeals follow the partnership rules (see IRC Sections 6241, 6242, and 6243).

4.8 Alternative Dispute Resolution

See Section 13.2 for a discussion of alternative means of dispute resolution available to taxpayers under audit, including Fast Track Settlement (FTS) and Fast Track Mediation (FTM).

5. HOW TO PREPARE FOR AN EXAMINATION

The IRS' audit procedures handbook can be ordered from Commerce Clearing House in three volumes entitled *Internal Revenue Manual: Audit.*

5.1 Preparing for Office or Field Examinations

In many office examinations and in most field examinations, the taxpayer is wise to have an accountant or other authorized representative present in place of the taxpayer. Note, however, that IRC Section 7602(a)(2) allows the IRS to summon the taxpayer to appear. This potential use of the administrative summons continues in force despite the Taxpayer Bill of Rights.

If an audit has begun without the presence of the taxpayer's professional adviser, the taxpayer can terminate the interview and request a new appointment at which the adviser will be present. The advantages to a taxpayer of professional representation center around the professional's

— Knowledge of tax law and interpretation.

— Familiarity with the audit process and the rules of disclosure.

— Ability to exhibit professional behavior toward the IRS agent.

Tax professionals should make clear to their clients, at the time a return is prepared, whether representation in an examination is included in the fee for preparing the return or will be extra. Normally, because of the difficulty in forecasting the amount of time required to represent a client in an audit, this service is billed separately when needed. Even if not appearing at the examination, the professional tax adviser may provide valuable assistance by putting together the documentation that will be needed at the interview.

5.1.1 Obtaining a copy of a tax return

Use IRS Form 4506 to request a copy of a tax return together with W-2 Forms. Form 4506 should be mailed to the office of the IRS where the return was originally filed. There is a small charge. An abbreviated version of a return, called a transcript, is available at no cost.

5.2 Burden of Proof: Documenting the Taxpayer's Position

The burden of proof for items in the return is on the taxpayer. Evidence, such as receipts and canceled checks, should be organized for presentation to the examiner. Important items of documentation should be photocopied in advance since examiners frequently request them. Original documents should be retained in case they will be needed in litigation.

Items about which doubt exists should be thoroughly traced to source documents. Ordinarily, inadvertent omissions or mistakes that are clearly minor in their effect can safely be admitted to the agent unless their total impact suggests a pattern of disregard of the rules. On the other hand, if the taxpayer provides the IRS with a voluntary admission of *fraud* plus the documentation to back it up, the taxpayer is in a precarious position. If a taxpayer has been dishonest in any but the most trivial matters, he or she should consult a criminal tax lawyer prior to attending an IRS audit.

In court proceedings, provided the taxpayer has met certain conditions, the burden of proof is on the IRS. For further reference, see 26 USC 60501, IRS Announcement 90-142 (1990-53 IRB 1), and IRS Publication 1544, "Rules for Reporting Large Cash Payments."

5.3 Beginning the Examination

Reassurance should be sought from the IRS examiner that a *civil* examination is in progress. If more than one examiner is present, each should be asked to identify his or her position in the IRS. There have been instances in which IRS special agents investigating fraud have apparently failed to identify themselves adequately or to give the IRS' modified form of the Miranda warning before the taxpayer made damaging admissions. The taxpayer's experienced tax lawyer will ordinarily be able to get this evidence suppressed in court. In most cases, however, the special agent will identify himself or herself properly. Upon any suspicion or suggestion that the IRS is considering a fraud investigation, the taxpayer should answer no questions and provide no documents until he or she has consulted a criminal tax attorney.

5.3.1 Tips for conduct

Experienced tax practitioners agree on the following tips for behavior during an examination:

— Contact the IRS agent before the audit to try to see the case with his or her eyes.

— Review the facts and the law relevant to the case well in advance of the audit date; know facts and the law better than the IRS agent.
— Organize documentation for presentation to the auditor.
— Advise the client on proper, respectful behavior or suggest that he or she not be present.
— Establish a courteous yet businesslike rapport with the agent.

Some practitioners advise allowing the agent to direct the audit; others try to lead the agent. The best approach is probably dependent on the personalities of the participants. Answer questions briefly, completely, and substantiate them by evidence.

Present only evidence asked for by the agent; do not give open access to the taxpayer's files or records.

5.3.2 Negotiation and settlement

Settlement with the examining revenue agent is usually advisable in order to resolve a case at the lowest level of inquiry. Revenue agents technically have no authority to make settlements with the taxpayer. They do, however, have discretion in determining the adequacy of documentation of factual issues. Negotiation may be entered into regarding items for which the agent proposes an adjustment.

If the issue in question is solely legal, rather than factual, the agent will take the IRS' stated position. Once this stance has been taken, any attempt at a different settlement will lead to an impasse.

In an effort to assist IRS personnel in settling cases, the national office can provide technical advice memorandums (TAMs), either during the examination or during an appeal. The revenue agents have instructions on how to obtain a technical advice memorandum. A request for a TAM may be made by the agent or the taxpayer.

5.4 Market Segments Specialization Program

The IRS Examination Division is preparing a series of industry-specific audit guides. This ongoing program, called the Market Segments Specialization Program (MSSP), is intended to tell revenue agents and tax auditors how certain industries operate. The following are *Market Segment Specialization Papers* and *Understanding Papers* issued through March 6, 2002.

Alaska Commercial Fishing Industry
Alternative Minimum Tax
Architects

Artists and Art Galleries
Attorneys
Auto Body and Repair Industry
Automobile Dealerships
Automobile Industry
Aviation
Bail Bond Industry
Bars and Restaurants
Beauty and Barber Shops
Bed & Breakfasts
Business Consultants
Car Wash
Carpentry and Framing
Child Care Providers
Coal
Commercial Banking Industry
Commercial Printing Industry
Computers, Electronics, and High Technology
Construction Industry
Drywallers
Entertainment Industry
Farming
Furniture Manufacturing
Garden Supplies
Garment Contractors
Garment Manufacturers
Gasoline Retailer Industry
General Livestock, such as horses, swine, ostrich, and others
Grain Farmers
Hardwood Timber Industry
Independent Used Car Dealers
Laundromats
Lawsuit Awards and Settlements
Low Income Housing
Manufacturing Industry
Masonry and Concrete Industry
Ministers
Mobile Food Vendors
Mortuaries
Moving Industry—Classification of Workers
Music Industry
Net Operating Losses for Individuals
Oil & Gas Industry
Partnerships
Passive Activity Losses
Pizza Industry
Placer Mining
The Port Project
Poultry Industry
Reforestation Industry
Rehabilitation Tax Credit
Retail Gift Shops
Retail Liquor Industry
Scrap Metal Industry
Shareholder Loans
Sports Franchises
Swine Farm Industry
Taxicabs
Tobacco Industry
Tour Bus Industry
Trucking Industry
Veterinary Medicine
Wine Industry

Many of MSSP Papers are available on the IRS Web site at www.irs.gov and can be purchased from the Superintendent of Documents at bookstore.gpo.gov/irs.

6. CRIMINAL AND CIVIL TAX FRAUD

Civil tax fraud differs from *criminal* tax fraud in that the latter is punishable by *imprisonment*, by fines, or by both. Civil tax fraud, on the other

hand, is punishable exclusively by a monetary penalty. An example is the 75 percent civil penalty provided in IRC Sec. 6663 for underpayments of tax that are due to fraud.

IRS special agents—members of the Criminal Investigation Division (CID)—seek first of all to discover and build a case for the prosecution of criminal fraud. According to the Internal Revenue Manual, CID is responsible for recommending and supporting with evidence whatever civil penalties may also be appropriate. If the criminal case fails, the IRS may propose civil fraud penalties. Acquittal of the criminal charges does *not* bar further pursuit of the taxpayer for civil fraud penalties. (*Helvering v. Mitchell,* 303 U.S. 391 (1938); *Spear v. Commissioner,* 91 T.C. 63 (1988)).

Criminal investigation's conviction rate is one of the highest in federal law enforcement. Not only do the courts hand down substantial prison sentences but those convicted must also pay fines, civil taxes, and penalties. Some federal tax crimes are felonies, carrying possible incarceration for longer than one year. Assisting in the preparation of a false tax return (IRC Sec. 7206(2)), for example, is a felony. It carries a maximum three-year jail sentence.

Certain other federal tax crimes are misdemeanors, punishable by imprisonment for one year or less. Failure to file a return, IRC Sec. 7203, is an example of a misdemeanor, carrying a possible maximum jail term of one year.

The standard of persuasion (also called the standard of proof) for any criminal conviction is that of proof of guilt *beyond a reasonable doubt.* In a civil case, ordinarily, proof need be only by a *preponderance of the evidence.* (That phrase is interpreted to mean that the great weight and merit of the evidence (over half) is against the defendant.) In U. S. Tax Court, however, Rule 142 requires that the government sustain its burden of proof of fraud by *clear and convincing evidence,* a more demanding standard than *preponderance* but less than *reasonable doubt.* (For further discussion of the Tax Court's standard see *Amos v. Commissioner,* 43 T.C. 50 (1964), aff'd, 360 F.2d 358 (4th Cir. 1965)).

Whenever fraud is an element of the offense, the government has the burden of proof. Because the standard of criminal proof, once achieved by the government, is higher than that for civil proof, the IRS will ordinarily recommend the 75 percent civil fraud penalty of IRC Sec. 6663 whenever a taxpayer is found guilty of a tax crime (or pleads no contest).

"Willfulness," an element of all of the major Internal Revenue Code tax crimes (and also an element in those statutes that prescribe civil penalties for fraud), refers to an intent to perform the illegal act—a voluntary, intentional violation of a known duty. An act done

inadvertently or by mistake, on the other hand, is not a crime. For example:

> A tax practitioner who for training purposes directed an employee to prepare a refund claim for a hypothetical client would not be guilty of a crime if a different employee inadvertently filed the claim with the IRS.

Some IRC sections specify civil penalties only, and the element of willfulness or intent to evade taxes is not pertinent. An example is IRC Sec. 6698 concerning failure to file a partnership return. In the case of a violation of these and similar statutes, penalties against a taxpayer or tax practitioner may be assessed by the IRS in a manner similar to the assessment of taxes. If the IRS cannot be convinced to remove the penalty administratively, the burden of proof in court is on the person against whom the penalty was assessed.

The 1998 act shifts the burden of proof in any court proceeding to the IRS on issues of fact if the taxpayer

— Introduces creditable evidence.
— Complies with any required substantiation requirements.
— Maintains adequate records.
— Cooperates with the IRS' reasonable requests for witnesses, documents, and meetings.

6.1 How Fraud Investigations Are Initiated

Most fraud investigations arise by referral from an IRS agent who is examining a tax return, but they may also be prompted by a tip from a taxpayer's spouse, neighbor, employee, or from a lead supplied by another government program, such as drug enforcement. A referral is a transfer to IRS special agents working from the criminal investigation division (CID) of an IRS district office. CID special agents conduct fraud examinations.

6.2 How to Detect That a Fraud Referral Has Been Made

Criminal division referral should be suspected if the revenue agent abruptly postpones or suspends the examination while being vague about the reason, particularly if preceding this action by

— Discovering false statements made by the taxpayer during interviews concerning income, deposits, or lifestyle.

— Interviewing the taxpayer's customers, employees, suppliers, bankers, and stockbrokers.

— Showing interest in beginning-of-the-year cash balances and asking probing questions about cash expenditures.

— Requesting cash-related documentation such as deposit slips, bank and brokerage statements, and canceled checks.

— Asking for permission to go through the taxpayer's files.

— Requesting photocopies of income-related items such as sales and accounts receivable records, shipping records, and bank statements.

— Asking for written statements of net worth, sources of cash, or expenditures of cash.

If a fraud referral is suspected, the taxpayer should immediately consult an experienced criminal tax attorney prior to making any statements or providing any documents to the IRS.

6.3 Cash Reporting Requirements

Any person in a trade or business who receives more than $10,000 in cash, either in a single transaction or in related transactions, must report these transactions to the IRS on Form 8300. Financial institutions and casinos report on Forms 4789 and 8362. A "person" is an individual, company, corporation, partnership, association, or estate.

"Cash" consists of coins and currency, whether of U.S. or foreign issue, cashier's checks (by whatever name, including bank checks and treasurer's checks), bank drafts, traveller's checks, or money orders.

"Related transactions" are those that occur within a twenty-four-hour period. If more than twenty-four hours pass between receipts of cash, and the total is greater than $10,000, the transactions must be reported if the recipient knows or has reason to know that each is one of a series of connected transactions.

Form 8300 must be filed within fifteen days of receipt of a payment. After filing, a new count of cash receipts begins. Additional receipts of over $10,000 must also be reported.

Persons reporting cash receipts must give a written statement to each payer named on any Form 8300, showing the name and address of the person reporting and the amount reported. This statement must be sent by January 31 of the year following the year in which the cash that triggered the IRS filing was received. A copy of Form 8300 must be retained for five years.

Civil and criminal penalties for intentional or willful disregard are provided in the amount of $25,000 ($100,000 for corporations) or the

amount of cash received in the transaction or related transactions (but no more than $100,000), and sentencing up to five years in prison, or both. Civil penalties apply for any failure to

— File a correct Form 8300.

— Provide the required statement to those named in the form.

— Comply with other information reporting requirements.

Criminal penalties apply in any instance of willful or intentional

— Failure to file a report.

— Filing a false or fraudulent report.

— Stopping or trying to stop a report from being filed.

— Structuring a transaction to make it appear unnecessary to file a report.

Voluntary filings may be made of cash transactions under $10,000 if the transaction appears suspect. Questionable cases may be discussed with the local IRS Criminal Investigation Division or by phoning 1-800-272-2877. A transaction is suspect if

— It provides an indication of possible illegal activity.

— It indicates an attempt by the payer to convince the recipient not to file Form 8300, or to file a false or incomplete form.

— The payer's appearance, demeanor, statements, or any other facts or circumstances arouse the suspicion of the recipient.

For further reference, see 26 USC 60501, IRS Announcement 90-142 (1990-53 IRB 1), and IRS Publication 1544, "Rules for Reporting Large Cash Payments."

Caution:
If an issue occurs, it is important that an attorney experienced in these matters be consulted.

7. RESULTS OF THE EXAMINATION

7.1 Consent to Assessment: Form 870

When the IRS revenue agent has completed the examination, the taxpayer or authorized representative has an opportunity to discuss the proposed adjustments and to argue, for example, that the taxpayer's substantial compliance justifies acceptance of inadequately substantiated amounts. Experienced tax practitioners believe they can do a better

job here than the taxpayer can. The IRS agent may act in a more conciliatory fashion when dealing with a fellow professional who may be perceived as a peer seeking a common goal, that of reaching a mutually agreeable and prompt resolution.

If the taxpayer and the agent reach an agreement as to liability, the agent will ask the taxpayer to sign a waiver, Form 870. Form 870 sets forth the taxpayer's name, taxable year, amount of tax due (including any penalties incurred) or amount of refund due to the taxpayer. This agreement at the district office level is not binding on either the taxpayer or the IRS, but the agent's recommendations will normally be accepted. The taxpayer who subsequently wishes to change position must pay the assessment and file a claim for a refund.

Taxpayers ordinarily sign the waiver if the assessment is based on obvious errors that they made in the return. Small assessments are best not disputed under the guise of standing up for a principle. (Interest charges stop running thirty days after signing of the waiver.) On the other hand, no taxpayer who feels the assessment is seriously overstated should sign the waiver.

If the taxpayer and the agent cannot agree on all the issues in question, they may still be able to reach a partial agreement and execute a waiver. A partial agreement allows computation of dollar amounts for at least some previously unresolved issues, calculation of the additional tax, and cessation of interest. The taxpayer must decide whether to yield on uncertain issues and save money on interest payments or take a chance that a better agreement can be reached on all issues at the appeals level.

Signing Form 870 does not prevent later filing for a claim for refund for any concessions the taxpayer agreed to but then decided were erroneous. Form 870-AD is an agreement form used in the appeals division. It specifies the taxpayer's agreement that "no claim for refund or credit shall be filed or prosecuted for the year(s) [covered by the agreement] other than for amounts attributed to carrybacks provided by law." Although there have been court decisions to the contrary, signing Form 870-AD makes it very unlikely that a taxpayer will be able to recover on a concession that is subsequently viewed as unwise.

Form 4549, Income Tax Examination Changes, is a similar agreement used in the audit division. If this agreement is signed, the taxpayer consents to immediate assessment and loses the right to challenge the liability in the Tax Court.

7.2 Extending the Statute

If negotiations at the examination stage (or later) continue until the statute of limitations approaches, the IRS agent may ask the taxpayer

to extend the statute. Form 872 extends the statute for assessment of taxes under examination to a time specified in the form. Form 872-A, Special Consent to Extend the Time to Assess Tax, extends the statute for an indefinite period. The taxpayer's consent to an indefinite extension on Form 872-A can be terminated *only* by use of the specific procedures stated in the form. Termination occurs ninety days after the date on which Form 872-T is mailed or 150 days after the date on which the IRS mails a notice of deficiency. (Form 872-T terminates the consent given on Form 872-A.)

Extending the statute extends the period during which negotiation or compromise can take place. Extension for a period of time different from that requested by the IRS can be requested and could possibly be of value to the taxpayer. If the taxpayer refuses to agree to extend the statute, the IRS normally issues a notice of deficiency requiring payment or the filing of a petition to the Tax Court within ninety days.

7.3 IRS Review of Agreed Cases

Although most agreed cases are not changed later, returns for these cases are subject to review by the district office. This provides the IRS with a safety valve to guard against improper agreements by inexperienced agents. A district examination case that has been closed will not be reopened except in the case of fraud, collusion, concealment, or misrepresentation of a material fact, or if there has been an error in the agreement based on the IRS position at the time of the agreement.

8. ASSESSMENT AND COLLECTION OF TAX

8.1 Assessment

The first step in the collection process is the assessment of the tax owed to the government. To assess means to create an account receivable on the government's books. Any tax, interest, or penalty the taxpayer owes to the government becomes an account receivable.

Regional service centers have assessment officers who sign summary records of assessment for each taxpayer for every taxable period. The date the summary assessment is signed is considered the date of the assessment. Taxpayers who wish to receive a copy of their assessments may do so upon request.

8.2 What the IRS May Assess

The IRS has the authority to assess the amount of tax shown on the return, with adjustments made for any mathematical or clerical errors appearing on the return. Additional tax may be assessed if there is a deficiency. (Also, certain penalties are assessable.)

8.2.1 Deficiency

A deficiency is defined as the portion of an income tax liability (including estate, gift, and other tax liabilities) for a taxable period that exceeds the tax previously paid with respect to the taxpayer's return for that particular period. If the IRS determines that a deficiency is present, the IRS must mail a notice of deficiency to the taxpayer by either certified or registered mail. Once the notice has been received, the taxpayer has the right to file a petition with the Tax Court asking that the deficiency be redetermined. If the taxpayer chooses to file such a petition, the IRS cannot assess the deficiency until the Tax Court issues a ruling on the case. If the taxpayer fails to file such a petition within ninety days of having received a notice of deficiency (150 days if the notice was addressed to a taxpayer outside the United States) or if the taxpayer waives the right to formal notice of the determination of a deficiency, the IRS may assess the deficiency.

8.2.2 Exceptions to the regular deficiency notice procedure

In several situations the IRS can follow a procedure other than the deficiency notice procedure described in section 8.2.1:

— *Mathematical and clerical errors.* If the IRS discovers mathematical or clerical errors on a return made after 1976, it must mail the taxpayer notice of assessment of the additional tax and allow the taxpayer sixty days after receipt of the notice to file a request for abatement of the assessment. During the sixty-day period, the IRS can make no efforts to collect the assessment. If the taxpayer chooses to file a request for abatement of the assessment, the IRS must abate the assessment and make any reassessments using the regular notice of deficiency procedure.

— *Voluntary payments before assessment.* The taxpayer may make a voluntary payment to prevent the accumulation of interest. Once the IRS receives the payment, it may assess the tax for the purpose of balancing its books. If the taxpayer wishes to take the case to the Tax Court, he or she must wait until after the IRS issues a notice of deficiency before submitting the payment, because making the

payment before the notice is received would eliminate the deficiency and cause the Tax Court to lose its jurisdiction over the case.

— *Appeals of Tax Court decisions.* If a deficiency in tax is found by the Tax Court, the tax will be assessed and collection efforts will begin even if the Tax Court's decision is not yet final. Collection may be deferred if the taxpayer posts a bond.

— *Bankruptcies and receiverships.* In the case of bankruptcies and receiverships, assessments are made immediately.

— *Waiver of restrictions.* The taxpayer who chooses to waive the restrictions on assessment may do so by filing Form 870 (Form 4549 if the matter is in the audit division, or Form 870-AD if the matter is at the appeals office). Filing a waiver of restriction allows the IRS to assess the deficiency immediately and terminates interest charges beginning thirty days after the effective date of the waiver. (See section 7.1.)

8.2.3 Statute of limitations on assessment

The general statute of limitations on assessments is three years after the later of the date the return was filed or the date the return was due. Before expiration of the three-year period, the taxpayer may consent to extend the period of assessment (except for estate taxes). Extensions may benefit taxpayers who expect that they can eventually negotiate a favorable settlement with the IRS. If a taxpayer refuses to consent to the extension, the IRS will issue a ninety-day letter (notice of deficiency) to protect itself against expiration of the assessment period. Taxpayer consent is indicated on Form 872. In the following situations, the statute is extended to six years:

— Omission of more than 25 percent of gross income

— Failure to report foreign personal holding company income

— Failure to provide the information requested on Schedule 1120 PH by a domestic personal holding company

In addition, deficiencies that result from the deduction of a carryback of a net operating loss can be assessed within the time period applicable to the year in which the net operating loss originated. If a false or fraudulent return has been filed with the intent to evade tax, or if no return is filed, there is no limitation on the period for assessment. Subsequent, voluntary filing of an amended return showing correct information does *not* limit the open-ended assessment period if the original return was false.

8.2.4 Individual master file

The IRS maintains an accounting for each taxpayer, showing debit and credit activity. An entry in this file, labeled "examination indicator," may signal that an audit is likely.

8.3 Collection

If the taxpayer fails to take advantage of opportunities to appeal an IRS decision to assess additional tax (see section 9), the IRS will use its powers of levy to collect the tax (IRC Section 6331(b)). The power of levy gives the government the right to seize and sell an asset.

Within sixty days after the expiration of the period begun with the mailing of a ninety-day deficiency letter, the IRS issues a notice and demand for payment. Collection cannot be enjoined by the taxpayer if the assessment itself is valid. At this point, the taxpayer can pay the tax and file a claim for refund with the IRS. If the claim is disallowed, the taxpayer can file an action in U.S. district court or in U.S. Claims Court. Alternatively, the taxpayer may file a petition with the U. S. Tax Court prior to making payment.

If the taxpayer fails to pay, the additional tax plus penalties and interest become a lien on property owned by the taxpayer or acquired after the lien is effective. The IRS has ten years to collect. The lien is not valid against certain claims, such as mortgages and other recorded liens, until a notice of tax lien (Form 668) is filed. The taxpayer has thirty days after the mailing of the notice of lien in which to demand a hearing before an appeals officer who has had no prior involvement in the case.

A notice of levy (Form 668-A) must be either (1) given to the taxpayer in person, (2) left at the taxpayer's home or usual place of business, or (3) sent to the taxpayer by registered or certified mail. The notice must be provided at least thirty days prior to seizure of the asset and must describe the procedures for sale and the appeals process available to the taxpayer, including that of a pre-levy hearing (IRC Sec. 6331(a)).

Levies against personal property are valid when notice is given to the holder of the property, such as a bank that holds the taxpayer's checking or savings account. Notice to the taxpayer may be made afterward. The effect of a levy is to transfer "constructive possession" of the property to the government, and any subsequent attempted assignment of the property by the taxpayer is invalid. A levy covers property owned by the taxpayer at the date of the levy or later acquired. A levy on salary or wages continues in effect until the liability is satisfied or the statutory period (usually six years) expires. Once the property has been levied

upon, the taxpayer may redeem it by purchase from the IRS (satisfying the tax deficiency) prior to public sale. Real property may be redeemed by the former owner within 180 days after its public sale by payment of the sale price plus 20 percent per annum to the purchaser (IRC Sec. 6337(b)). Certain property is exempt from IRS seizure, including

- — Clothing, food, fuel, and schoolbooks
- — Furniture and personal effects (limit of $6,890)
- — Books and tools used in a trade, business, or profession (limit of $3,440)
- — Salary, wages, or other income to the extent ordered by a court to support minor children
- — Payments for disabilities in connection with military service
- — Certain federal or state public assistance payments, such as supplemental income for the aged or blind
- — Other items specified in IRC Sec. 6334(a) and Treas. Reg. Sections 301.6334-1 through 301.6334-7

Ordinarily, the taxpayer's principal residence is exempt from levy unless the Secretary of the Treasury finds that collection is in jeopardy (IRC Sec. 6334). A federal judge or magistrate also must approve the levy in writing.

According to IRS policy, levies are not made against qualified pension plan benefits or IRAs, or against Social Security, Medicare, or welfare payments. This IRS policy is subject to change.

Exemptions provided by state law are not effective to prevent levy for the collection of any federal tax.

The American Jobs Creation Act of 2004 authorizes the IRS to use private debt collection agencies (PDCs) to collect outstanding federal tax liabilities. The use of PDCs is anticipated to increase collection efforts against taxpayers. The proposed use of PDCs has been controversial and, to date, the IRS has not used PDCs to collect tax liabilities.

8.4 Safeguards Against IRS Seizure

- — No levy can be made on property if the estimated amount of expenses to be incurred during sale exceeds the fair market value of the property (IRC Sec. 6331).
- — A levy must not be made on a day when the owner of the property is required by summons to appear before the IRS, unless collection of the tax is in jeopardy (IRC Sec. 6331).

— After receiving official notice of levy, banks and other financial institutions cannot release garnished accounts for twenty-one days (IRC Sec. 6332).
— Levies must be released if the liability is satisfied, release facilitates collection, an installment agreement has been signed, economic hardship results, or the fair market value of the property exceeds the liability. Determination of economic hardship must be expedited in the case of tangible personal property essential to the taxpayer's trade or business (IRC Sec. 6343).
— The taxpayer's residence cannot be seized for a liability of $5,000 or less. Generally, a taxpayer's primary residence cannot be seized without the approval of a federal judge or magistrate.
— The IRS cannot seize the taxpayer's business unless other assets are not sufficient to cover the liability.
— At the taxpayer's request, seized property must be sold within sixty days (IRC Sec. 6335).
— Jeopardy assessments or jeopardy levies must be explained in writing and reviewed by the IRS within thirty days if the taxpayer requests (IRC Sec. 7429).
— Civil actions to review the reasonableness of jeopardy assessments and levies may be brought in federal district court or, in certain circumstances, in Tax Court (IRC Sec. 7429).
— A taxpayer who receives a Notice of Tax Lien or a Final Notice of Intent to Levy is entitled to a Collection Due Process (CDP) hearing (see Section 8.8).

8.5 Compromise

After assessment, but before payment (or levy), one additional recourse may be available. It may be to the taxpayer's advantage to attempt a compromise with the IRS. In exchange for a speedy and relatively certain settlement, the IRS may be willing to accept less than the full amount of liability. Acceptance of an offer in compromise (Form 656) is discretionary with the IRS.

Traditionally, a compromise must have as its basis doubt about either liability or collectibility. A compromise offer based on doubt about liability will be rejected by the IRS if the liability has been determined by the Tax Court or by the IRS appeals office. An offer to compromise based on collectibility must be accompanied by a statement on Form 433-A of the taxpayer's assets, liabilities, income, and living expenses, since the taxpayer's argument is that he or she will be unable to pay the amount of tax that was assessed. (Form 433-B is used for

businesses.) No compromise is accepted unless the taxpayer agrees to extend the period of limitation on collection for the time the offer is under consideration, plus one year (Treas. Reg. Sec. 301.7122-1(f)). In addition to doubt as to liability or collectability, a compromise may be based on "effective tax administration" if collection in full would cause the taxpayer economic hardship, or where compelling public policy or equity considerations provide a sufficient basis for compromising the liability.

Taxpayers who owe $10,000 or more are subject to new collection and budget rules. If there are no readily available assets to sell or borrow against, the taxpayer's monthly gross income less necessary living expenses is calculated to yield a minimum acceptable installment payment. The housing and transportation component of necessary living expenses is dependent upon local conditions. National standard expenses have been calculated to cover other necessary expenses such as housekeeping supplies, clothing and clothing services, personal care products and services, food and miscellaneous. Dollar amounts are derived from the Bureau of Labor Statistics Consumer Expenditure Survey and are updated periodically (see Internal Revenue Manual, Sec. 5323). The Survey can be obtained from the Bureau of Labor Statistics, 2 Massachusetts Avenue, Room 3985, Washington, D.C. 20212, (202) 606-6900.

The taxpayer will be expected to offer to pay the net realizable value of his or her equity in the assets. This value is equal to the quick-sale value of all assets minus debts that have priority over the IRS. For nonliquid assets, such as real estate or closely held business interests, quick-sale value is 80 percent of fair market value. Additionally, the taxpayer will be expected to pay the present value of four years of future income less certain necessary expenses.

There is a $150 user fee to request a compromise. The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) added a requirement that a taxpayer seeking an offer in compromise must submit, with the request, an amount equal to 20 percent of any lump sum offered, or 100 percent of the amount of the first offered payment if a series of payments is offered. Guidance regarding offers in compromise can be found in Rev. Proc. 2003-71, I.R.B. 2003-36.

8.6 Installment Payment (IRC Sec. 6159)

The IRS is authorized to enter into a written agreement with any taxpayer allowing satisfaction of a tax liability through payments under an installment plan, if it facilitates the collection of the liability.

IRS Divisions of Appeals, Employee Plans and Exempt Organizations, Examination, Problem Resolution, Returns Processing (in service

centers), and Taxpayer Service are authorized to make installment agreements up to $10,000. Their authority extends over individual, corporate accounts involving Form 1120, and out-of-business sole proprietor accounts. Larger amounts are addressed by the Collection Division. If the aggregate liability does not exceed $10,000, the taxpayer has filed all returns for the past five years, the taxpayer is financially unable to pay, and the agreement requires full payment within three years, the IRS is required to enter into an installment agreement. The IRS generally follows this simplified procedure for tax liabilities up to $25,000, and generally allows taxpayers up to five years to pay the tax liability in full.

It is not necessary for a taxpayer to be assessed a deficiency before opening the possibility of installment payment. On IRS Form 9465, Installment Agreement Request, the taxpayer proposes a monthly payment at any time he or she is unable to satisfy the tax liability. A small fee is imposed by the IRS for such an agreement. The IRS will respond within thirty days, approving or denying the request or asking for more information.

Interest and penalties (including the failure to pay penalty applied at a reduced rate) continue to accrue until the liability is satisfied. (Financial sources other than the Treasury may provide the taxpayer with lower rates of interest.)

Generally, an agreement entered into will remain in effect for the term of the agreement. On thirty days' notice, however, the government may alter or terminate the agreement if it finds the following:

— The taxpayer provided information prior to the date of the agreement which was inaccurate or incomplete.

— The collection of the tax is in jeopardy.

— The financial condition of the taxpayer has significantly changed.

Note: The American Jobs Creation Act of 2004 authorizes the IRS to enter into an installment agreement that provides for payment of less than the entire tax liability owed (a "part payment agreement"). Previously, the IRS was only permitted to enter into an installment agreement providing for payment of 100% of the tax liability due. A part payment agreement combines the benefits of an offer in compromise with the benefits of an installment agreement.

8.7 Dischargeability of Taxes in Bankruptcy

8.7.1 Individuals

The discharge of a particular tax obligation depends on the nature of the tax, the priority status granted to tax obligations under the Bankruptcy Code, and the chapter of the Bankruptcy Code under which the

case is filed or to which a case may later be converted. 11 U.S.C. Section 523(a) details debts of an individual, including various taxes, that, unless paid, are not discharged in a bankruptcy proceeding under Chapter 7, Chapter 11, Chapter 12, or by a debtor who receives a "hardship" discharge under Chapter 13. See 11 U.S.C. Section 1328(b).

Taxes exempted from discharge include instances when a debtor failed to file a required return, filed a late return within two years of filing the bankruptcy petition, filed a fraudulent return, or willfully attempted to evade such tax. In a case filed under Chapter 13 prior to October 17, 2005, and upon completion by the debtor of all payments under the plan, the court will grant the debtor discharge of all debts provided for in the plan, including taxes (including those related to unfiled returns or fraud) (See 11 U.S.C. Section 1328(a)). The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the 2005 Bankruptcy Act) eliminated the distinction for Chapter 13 cases filed on or after October 17, 2005. Prepetition penalties and interest related to taxes that are not discharged are likewise not discharged.

Priority taxes under 11 U.S.C. Section 507(a)(2) that are exempted from discharge relate to taxes incurred by a debtor in an involuntary proceeding between the date the involuntary petition is filed and the date the Bankruptcy Court enters an order for relief. Priority taxes under 11 U.S.C. Section 507(a)(7) that are exempted from discharge include the following:

— Income taxes due within three years of the filing of the petition, assessed within 240 days of the filing of the petition, or unassessed but assessable as of the filing of the petition. See 11 U.S.C. Section 507(a)(7)(A).

— Property taxes. See 11 U.S.C. Section 507(a)(7)(B).

— Withholding taxes, such as income tax or FICA and "collected" taxes, such as telephone excise tax, airport ticket tax, and windfall profits tax. See 11 U.S.C. Section 507(a)(7)(C).

— Certain employment taxes, such as FICA and federal and state unemployment taxes due on wages earned or paid before the petition is filed. See 11 U.S.C. Section 507(a)(7)(D).

— Excise taxes for a return, if required, that are past due within three years of the filing of the petition. See 11 U.S.C. Section 507(a)(7)(E).

— Certain customs duties. See 11 U.S.C. Section 507(a)(7)(F).

— Penalties that represent compensation for actual pecuniary loss for a governmental unit involving a tax listed in items A through F above. See 11 U.S.C. Section 507(a)(7)(G).

8.7.2 Partnerships and corporations

In a case filed under Chapter 7, 11 U.S.C. Section 727(a)(1) provides that only an individual can be granted a discharge. As such, partnerships and corporations involved in a proceeding under Chapter 7 are not granted a discharge. Therefore, if shareholders keep dormant a corporate shell for later reactivation, the unpaid tax liabilities remain in existence.

In a case filed under Chapter 11, 11 U.S.C. Section 1141(d) provides that upon confirmation of a plan of reorganization—unless otherwise provided for in the plan, in the order confirming the plan, or in that subsection of the statute—a debtor is discharged from any debt that arose before the date of confirmation. The historical notes to 11 U.S.C. Section 1141 clearly indicate that nondischargeable taxes in such reorganizations are priority taxes under 11 U.S.C. Section 507, and postpetition payments are due under agreements reached with the tax authorities before the commencement of the case. In addition, the 2005 Bankruptcy Act provides that confirmation of a Chapter 11 plan does not discharge a debtor that is a corporation from a debt for taxes with respect to which the debtor made a fraudulent return, or if the debtor willfully attempted in any manner to defeat the tax.

In a case filed under Chapter 12, 11 U.S.C. Section 1228(a) provides that after completion by the debtor of all payments under the plan, the debtor is discharged from all debts provided for by the plan, except any debt (e.g., taxes as described above) specified in 11 U.S.C. Section 523(a). Since the "family farmer" debtors eligible to file under Chapter 12 include partnerships and corporations, it would appear that this discharge, which is not as comprehensive as that under Chapter 11, applies to partnerships and corporations that are eligible and choose to file under Chapter 12 instead of Chapter 11.

> ***Practice Note.*** A number of provisions of the 2005 Bankruptcy Act have implications for tax practitioners. See the chapter on Bankruptcy/Insolvency for a detailed discussion of the 2005 Bankruptcy Act.

8.8 Collection Due Process Hearing

Sections 6320 and 6330 of the Internal Revenue Code require the IRS to deliver a written notice to a taxpayer, within five days after the filing a federal tax lien (IRC Section 6320) and prior to making a levy (IRC Section 6330), informing the taxpayer of the taxpayer's right to have a collection due process (CDP) hearing in front of an IRS Appeals Officer.

A CDP hearing allows a taxpayer the opportunity to raise defenses to the collection action, such as claiming innocent spouse relief, and

to discuss collection alternatives, such as offer in compromise and installment agreement. In addition, the taxpayer can raise issues regarding the validity of the underlying tax deficiency, but only if the taxpayer has not previously had the opportunities to raise those issues. If a taxpayer requests a CDP hearing, collection activity, and the statute of limitations on collection, is suspended until 90 days after the final resolution of the matter. A taxpayer can appeal an adverse decision by the Appeals Officer to the Tax Court, which will review the decision of the Appeals Officer on an abuse-of-discretion standard.

9. APPEALS PROCESS

Upon a taxpayer's disagreement with a revenue agent's determination of deficiency, a review and appeals process begins. When the taxpayer declines to sign Form 870 or Form 4549, the agent prepares a report that is reviewed by a supervisor and then sent to a technical branch of the district office examination division. (See section 7.1.) In most cases, the technical reviewer approves the findings of the agent and the taxpayer is sent a "thirty-day letter."

9.1 The Thirty-Day Letter

The thirty-day letter informs the taxpayer of proposed changes in tax liability. In addition, the thirty-day letter invites the taxpayer to a hearing before the appeals office, which is separate from and independent of the IRS office that proposed the adjustment to taxpayer's tax returns.

Tax practitioners who are on record as the taxpayer's representative receive the letter instead of the taxpayer if a power of attorney (Form 2848) or information authorization form (Form 8821) is on file. As the name implies, the taxpayer has thirty days to respond to a thirty-day letter.

Upon receipt of a thirty-day letter that proposes a deficiency, the taxpayer may request a conference with the appeals office. An oral request is sufficient if the deficiency resulted from a field examination in which the proposed deficiency is $2,500 or less or from an office or correspondence examination. If the deficiency resulted from a field examination in which the proposed amount exceeded $2,500 but did not exceed $25,000, a simple recitation of disputed issues to the appeals office is sufficient to get consideration. The dollar limits are calculated to include proposed additional tax, including penalties, proposed overassessment, and claimed refund (or, in an offer in compromise, the total

amount of assessed tax, penalty, and interest sought to be compromised) (Code of Federal Regulations [CFR], 601.106(a)(iii)).

If the proposed amount arising from a field examination is over $25,000, a formal written "protest" must be filed. Additionally, a written protest is required in cases involving all employee plan and exempt organization cases and all partnership and S corporation cases. When a formal protest is required, it must contain

- A statement that the taxpayer wishes to appeal the findings of the IRS agent.
- The taxpayer's name, address, and identification number.
- Identification of the years or periods involved.
- An itemized schedule of the proposed adjustment with which the taxpayer disagrees.
- A statement of facts that support the taxpayer's position, declared to be true under penalties of perjury.
- A statement of the law or other authority relied upon by the taxpayer.

(Text continued on page 53)

If an authorized tax representative submits the protest, it must state whether he or she knows personally that the statement of facts is true and correct. Guidance regarding protests is given in IRS Publication 5, *Appeals Rights and Preparation of Protests.*

IRS field examiners must inform taxpayers of the IRS's rebuttal position in protested cases, according to the executive director of the IRS Office of Coordinated Examination Programs. In cases where unagreed issues are being forwarded to the IRS Appeals Division, the Examination Division will provide taxpayers with the IRS's rebuttal position on the issues in question. Taxpayers wishing early referral to the Office of Appeals should consult Rev. Proc. 99-28.

9.1.1 The appeals office

The appeals office normally receives a case within thirty days of filing of a protest. It is policy to acknowledge receipt of the case within twenty-five days. A conference at the appeals office will then be offered within ninety days of receipt. Conferences are scheduled for both docketed and undocketed Tax Court cases. Approximately 85 to 90 percent of cases it receives are agreed and resolved by the appeals office, about 80 to 90 percent of them within one year.

Hearings at the appeals office are informal sessions in which no sworn testimony is taken. In matters in which facts are being alleged, however, affidavits may be required or it may be required that facts be declared to be true under the penalties of perjury. Practitioners who attend hearings without the taxpayer must have a power of attorney.

9.1.2 The appeals officer

Nationally, there are about 1,500 appeals officers. Many of them are CPAs or attorneys. They have the job of settling legal and factual issues raised by agents without resorting to litigation. They will not reopen issues that have been agreed upon by the taxpayer and the agent. They may, however, raise new issues if they feel there is a substantial reason for doing so—a possibility to be weighed when considering an appeal.

Appeals officers can request technical advice from the national office if either they or the taxpayer desires. The appeals officer is obligated to follow technical advice that is favorable to the taxpayer but may still negotiate if the advice is unfavorable to the taxpayer. If the taxpayer reaches an agreement with the appeals officer, the taxpayer signs Form 870-AD. If no agreement can be reached, a notice of deficiency (ninety-day letter) is issued and the taxpayer is invited to start proceedings in Tax Court. Even if an appeals officer reaches an agreement with a taxpayer, the agreement is not binding on the IRS

unless approved by the associate chief or chief of the appeals branch office.

9.1.3 Alternative dispute resolution

See Section 13.3 for a discussion of the alternative means of dispute resolution now offered by Appeals, including mediation and arbitration.

9.2 The Ninety-Day Letter

The ninety-day letter is the notice of deficiency received by a taxpayer who makes no response to a thirty-day letter, who requests immediate assessment in order to go to court, or who has reached no settlement in the appeals office. A taxpayer receiving a ninety-day letter has ninety days to file a petition with the Tax Court (150 days if it was addressed to a taxpayer outside the United States). The taxpayer who chooses to appear before the Tax Court does not first have to pay the proposed deficiency. If the taxpayer fails to respond in time to the ninety-day letter, the deficiency is assessed and the taxpayer loses the right to have his or her case reviewed by the Tax Court. A taxpayer who chooses to have the case reviewed by the U.S. district court or the U.S. Claims Court must pay the tax and then file for a refund.

9.3 Appeals Before the Courts

9.3.1 The U.S. Tax Court

Ordinarily, the Tax Court presents the taxpayer's only opportunity for entry into court without first paying the alleged deficiency. Timing is critical when petitioning the Tax Court. The petition must be received by the court no more than ninety days from the date the deficiency notice was mailed to the taxpayer.

If the case had been to the appeals office before the ninety-day letter was issued, IRS regional counsel has jurisdiction from the time the taxpayer files a petition in Tax Court. If the case had not been to the appeals office, regional counsel will refer it there. If the appeals office sees no prospect for settlement, and the deficiency is more than $10,000, the case will promptly be returned to regional counsel for trial preparation. If the deficiency is $10,000 or less, the appeals office will retain jurisdiction for at least six months, which period may be extended if there appears to be likelihood of settlement. In most cases it will be to the taxpayer's benefit to achieve settlement as rapidly as possible.

When jurisdiction of a case passes to IRS counsel, all relevant facts and legal positions will be pieced together to develop the case for trial.

Once the case is developed, regional counsel may attempt settlement with the taxpayer, regardless of prior settlement attempts by the IRS appeals division.

In contrast to other U.S. courts, representation before the U.S. Tax Court is not limited to attorneys. A taxpayer can represent himself or herself before the Tax Court or may be represented by anyone authorized to practice before the Tax Court (see section 2.1). Only tax cases are heard in Tax Court, and the court is accustomed to the complexities of the Internal Revenue Code. Cases heard by the Tax Court can be appealed to the U.S. Court of Appeals and may be heard in some instances by the U.S. Supreme Court.

For cases involving deficiency determinations of $50,000 or less for a taxable year, the taxpayer has the option of choosing to use the Small Tax Case Procedure. This procedure uses special trial judges whose decisions cannot be appealed. Results cannot be used as a precedent for any other case. Overall, the Small Tax Case Procedure is quicker, less expensive, and less formal; however, there can be no appeal. Recent statistics indicate that the IRS achieves a clear victory in 45 to 60 percent of the cases, regardless of the forum (Tax Court, district court, or Court of Federal Claims), although "split decisions" carrying some benefit to the taxpayer are more common in Tax Court. (The booklet *Election of Small Tax Case Procedure and Preparation of Petitions* is available from the Clerk of the Tax Court, 400 Second Street, N.W., Washington, D.C. 20217.) Once a taxpayer has filed a petition to the Tax Court it cannot be withdrawn, except with IRS counsel's agreement.

9.3.2 The U.S. District Court and the U.S. Court of Federal Claims

If a taxpayer has paid the assessed tax and has filed a claim for a refund, but the claim either has been denied with a notice of disallowance or has not been acted upon within six months from the date it was filed, the case may be taken to a U.S. district court or the U.S. Court of Federal Claims. In almost all district courts and the Court of Federal Claims, the government is represented by attorneys from the tax division of the Department of Justice.

District courts provide a taxpayer with the opportunity to have the case decided upon by a jury. In addition, since the district court is a local court, its members are likely to be familiar with local conditions and circumstances that may have a bearing on the outcome of the case. The U.S. Court of Federal Claims is not a local court, but the trial may be held in or near the taxpayer's home city. Since the judge in a Court of Federal Claims case will hear evidence at several locations for the convenience of parties involved, the Court of Federal Claims can often

ease problems created by having witnesses residing in widely scattered locations.

Decisions made by a district court can be appealed to the respective courts of appeal and ultimately, under the proper circumstances, to the Supreme Court. Decisions made by the Court of Federal Claims can be appealed to the U.S. Court of Appeals for the federal circuit and to the Supreme Court. Experienced tax attorneys choose a court based upon their experience with the court and subjective judgments about what is best for the taxpayer.

10. OBTAINING A REFUND

10.1 Claims Procedures

A taxpayer who has made an overpayment of taxes to the IRS is eligible for a refund. Overpayments exist when the taxpayer makes a tax payment exceeding his or her correct tax liability and include payments of taxes assessed or collected after the expiration of the period of limitations on assessment. If the IRS learns of an overpayment, either through notification by the taxpayer or through an audit, it will credit or refund the overpayment provided that the statute of limitations for filing claims (IRC Sec. 6511) has not expired.

Filing a refund claim puts the IRS on notice that there may be an overpayment. No lawsuit for a refund may be brought unless a timely and valid refund claim is filed. Although the IRS has issued denials, many tax practitioners believe filing a refund claim can sometimes trigger an audit, particularly if the refund is large or is made in connection with a tax shelter. A claim for refund may be made by

— Form 1040X or 1120X, Amended Returns, in the case of individual or corporate income tax.

— A regular tax form marked *Amended* and showing overpayment of income taxes.

— A letter to the appropriate IRS official stating all information necessary for the IRS to determine the nature of the claim.

— Form 870 showing an overpayment, solicited by a revenue agent and signed by the taxpayer.

— A Tax Court petition, or protest, containing allegations that a refund is due, partially mitigating a proposed deficiency and stating the reasons therefor.

10.2 Speedy or Quick Refund Procedures

Taxpayers may avail themselves of an expedited refund procedure referred to as "speedy" or "quick" because the IRS must either pay the refund or deny the application within ninety days from the later of either the date the application was filed or the last day of the month the return was due (considering extensions). If the IRS later audits the tax year, the refund may be denied retroactively, and the taxpayer may have to return the refund.

The forms to be filed are Form 1045, for an individual, or Form 1139, for a corporation. Technically, these forms constitute applications for a tentative carryback adjustment when a prior taxable year has been affected by

— A net operating loss carryback.

— An investment credit carryback.

— A work-incentive program carryback.

— A capital loss carryback.

10.3 Interest on Refunds and Underpayments

For refunds originating in the current-year tax return, there is a forty-five-day interest-free period starting with the due date or the filing date, whichever is later. For refunds based on a claim—the usual case—interest is payable to the taxpayer from the date of the overpayment to a date as much as forty-five days prior to the refund check date.

For an overpayment arising from a carryback, interest is payable to the taxpayer from the due date for filing the loss-year return (without regard to extensions) to a date not more than thirty days preceding the date of the refund check (IRC Sec. 6611(a), (b)(2), and (f)).

For periods beginning after July 22, 1998, the interest rate on overpayments and underpayments is equalized. For the same amount of tax due and owed the interest rate for the taxpayer is effectively zero.

10.4 Protective Refund Claim

A claim for refund must be filed within three years from the time the return was filed or two years from the time of payment of the tax. The claim must set forth in detail the basis for the refund (Treas. Reg. Sec. 301.6402-2). However, facts necessary to detail the claim may be unavailable to the taxpayer before the expiration of the limitation

period, such as the exact amount, or the effect of pending litigation. A claim for refund may be filed as a protective measure, however, even without complete detail. A general counsel memorandum acknowledges that the claim will be valid if it apprises the IRS of the essential nature of the claim (GCM 38786).

11. RULINGS, DETERMINATIONS, TECHNICAL ADVICE

11.1 Private Letter Rulings

A private letter ruling or, simply, a letter ruling is a written statement from the national office of the IRS specifying the tax treatment to be accorded a transaction or proposed transaction prior to its inclusion in a tax return. To the practitioner, a letter ruling is a planning tool, enabling taxpayers to obtain definitive guidance in structuring transactions. This guidance is particularly important if substantial amounts are involved and the transaction can be structured in different ways, depending on the IRS view as expressed in the letter ruling. The ruling may also motivate the taxpayer to avoid an as-yet-uncompleted transaction.

Rulings may not be cited as authority for another taxpayer's situation nor, technically, are they binding on the IRS. Only in rare instances, however, do examining agents attempt not to follow the ruling, in which case the ruling should be called to their attention. Rulings, with identifying characteristics removed, are available for public scrutiny and appear in tax publications. A ruling has no value, even to the taxpayer who received it, if the facts of the transaction are not in agreement with those supplied when the ruling was requested.

A conference at the national office may be requested to sound out the government's position, particularly if the transaction is complex or unique, without fully exposing the taxpayer's proposed situation. Taxpayers or authorized representatives should go to a conference with a draft of their request. Nothing said at the pre-submission conference is binding on either party.

The taxpayer must sign a statement attesting to the accuracy of the facts submitted in the filing. A thirty-day period will be allowed for submission of missing information. A request may be withdrawn by a taxpayer prior to the time the ruling is signed by the IRS. Rulings normally require several months for the IRS to process.

Although it is normal procedure to file the request and then to receive one conference as a matter of right, a phone call to the deputy

associate chief counsel for technical matters in the national office may prove useful in sounding out, before filing, whether the IRS is likely to issue a favorable ruling. No ruling will be made orally. The telephone call can also be used to straighten out procedural questions regarding the form of the submission. The telephone conference will proceed on a "time available" basis at the discretion of the deputy counsel.

If a formal ruling is sought, the request must be in writing and should be accompanied by copies of financial statements, minutes of meetings, and other pertinent documents. These will not be returned if the ruling is denied, but will become part of the taxpayer's file at the district level. Tax returns reflecting transactions carried out despite a prior unfavorable ruling are likely to be audited. Each year guidelines for securing letter rulings are detailed in a Revenue Procedure, for instance Rev. Proc. 2007-1, including such matters as the following:

- Submit in duplicate if more than one issue is requested, or if a closing agreement is requested.
- Do not submit alternative plans as backup in case your ruling is denied.
- Include complete facts, names, addresses, and identification numbers of all interested parties; copies of all pertinent documents should have an attestation that they are the same as the originals.
- Include a balance sheet nearest the date of the transaction.
- Include analyses that tie together the business reasons for the transaction.
- Give appropriate grounds and authority for the ruling.
- State the outcome of any previous request for rulings on similar issues for the taxpayer.
- State whether the same issue is in the taxpayer's return that (1) is under examination or appeal and without a closing agreement, or (2) is in litigation.

The areas in which the IRS will not issue letter rulings are set forth in a revenue procedure issued by the IRS each year.

11.2 Determination Letters

A determination letter, issued by a district director at the taxpayer's request, is a written response to a set of facts regarding a completed transaction. The determination is made only if it can be based on precedents and policies previously expressed by the national office. Procedures for requesting determinations are the same as for a letter

ruling, but the request should be directed to the district director. Forms are available for determining the tax qualified status of tax-exempt organizations (Form 1023), or pension, profit-sharing, or retirement plans and the trust or custodial arrangements associated with them (forms in the 5300 series). The procedures for requesting determination letters are set forth in Rev. Proc. 95-4 and in a revenue procedure issued by the IRS each year.

11.3 Technical Advice Memoranda (TAM)

These memos are statements written by the national office to provide instruction to a district or appeals office regarding the national office view of the treatment of a technical matter on a return under examination. These memos have other uses; for example, a district director might request technical advice concerning a taxpayer's request for a determination letter. Although the formal request to the national office must come from the district office, a taxpayer may request that this be done. Practitioners usually encounter TAMs when they are requested by a revenue agent. Taxpayers may submit their arguments either in writing or orally before the national office writes its memo.

A TAM may be particularly useful for the taxpayer who believes that lack of uniformity exists in treatment of an issue or that the issue is unusual enough to justify national office attention, while at the same time believing the national office will endorse the taxpayer's point of view, even if the examining agent does not.

An agent who has received a TAM is bound to follow its guidance. The legal issue involved may not be negotiated at the examination nor at the conference level, although a factual or monetary compromise may still be possible. The taxpayer's only other recourse is to go to court.

If the taxpayer asks for a TAM but the agent declines to request it from the national office, the taxpayer, within ten calendar days, should appeal in writing to the Chief, Examinations Office, or the Chief, Appeals Office. If another denial is received, the taxpayer has ten days in which to request that all data regarding the request be submitted to the national office. Details may be found in Statement of Procedural Rules 601.105(b)(5). Procedures for obtaining TAMs are set forth in a revenue procedure issued by the IRS each year.

11.4 Freedom of Information Act

The Freedom of Information Act (5 USC 552) requires the IRS to make available a variety of information if it has not already been published in the Federal Register, including

— Final opinions and other orders made in the adjudication of cases.
— Statements of policy and interpretations adopted by the IRS.
— Administrative staff manuals and instructions to staff that affect a member of the public.

Public reading rooms where these and other materials are available for inspection are maintained in the national office and in each regional office. Subject to exceptions set out in Statement of Procedural Rules 601.701(b)(1), a taxpayer may request that the IRS make available its "reasonably described records" concerning the taxpayer. (Exceptions relate primarily to IRS personnel rules and to enforcement tactics, including criteria for selection of returns for audit.) A request for records and files must be made in writing, stating it is made pursuant to the Freedom of Information Act and sent to the IRS official responsible for the records. Addresses for the responsible district officers, as well as details for making the requests, may be found in Statement of Procedural Rules 601.702. IRS Publication 876 gives information about the nature and possible use of IRS data banks.

11.5 User Fees for IRS Services

The IRS is required by statute to collect fees for certain services, such as issuing written determinations to taxpayers. The fee must be paid in advance and varies in amount depending on the time required or the complexity of the response to the taxpayer's request. Fee amounts are set in a revenue procedure issued early each year. The general fee for requesting a private letter ruling is $10,000. Reduced user fees are available for certain issues and for certain lower income taxpayers.

11.6 Closing Agreements

IRC Section 7121 authorizes the IRS to enter into agreements in writing that "shall be final and conclusive" regarding a person's tax liability. Shareholders desiring to sell a closely held corporation might seek a closing agreement to definitely establish the amount of the corporation's tax liability. An individual might seek a closing agreement to present to other creditors to help prove his or her financial position. Closing agreements might be used to

— Determine the amount of deficiency dividend to be paid to avoid personal holding company tax.
— Release the executor of an estate from tax liability.
— Determine the amount of a final distribution from a trust or estate.

According to Statement of Procedural Rules 601.202 (26 CFR 601.202), a taxpayer request for a closing agreement should be submitted to one of the following:

— District director with whom the return was filed

— Appeals division, if the matter is under appeal

— Commissioner of Internal Revenue, if the matter relates only to a subsequent period

Form 866, "Agreement of Final Determination of Tax Liability," is used to close out the total tax liability of the taxpayer—for example, by a fiduciary seeking to close an estate or by a corporation being liquidated. Form 906 is for a closing agreement covering specific issues. It might be used for matters having a continuing relevance to future tax years, such as to settle the basis of property or method of depreciation.

11.7 Correspondence

The IRS has provided an explanation of the notice routine and time frames for accounts with outstanding balances and accounts where no tax return has been filed. The first notice a taxpayer receives indicating a balance due is called an *adjustment/error notice.* There are several different adjustment/error "CP" notices that are used to alert the taxpayer of an outstanding balance.

Time Frames for IRS Notices

Balance Due Accounts

Individual Tax Accounts: Adjustment/Error Notice:

–5 weeks - 1st Notice, CP501
–5 weeks - 2nd Notice, CP502
–5 weeks - 3rd Notice, CP503
–5 weeks - 4th Notice, CP504

Business Tax Accounts: Adjustment/Error Notice:

–5 weeks - 1st Notice, CP503
–4 weeks - Final Notice, CP504

Return Delinquency

Individual Tax Accounts: 1st Notice, CP515

–8 weeks - 2nd Notice, CP516
–6 weeks - 3rd Notice, CP517
–6 weeks - 4th Notice, CP518

Business Tax Accounts: 1st Notice, CP515

–10 weeks - 2nd Notice, CP517
–6 weeks - 3rd Notice, CP518

12. PROBLEM RESOLUTION: NATIONAL TAXPAYER ADVOCATE

The Office of the National Taxpayer Advocate is an independent organization that is responsible for representing the taxpayer's point of view within the Service. Taxpayers feeling that their problems are not resolved through normal IRS channels may request an Advocate's help by filing Form 911, Application for Taxpayer Assistance Order (TAO). The form is available by phone (800-829-1040) or at a local IRS office.

Each state and service center has at least one Local Taxpayer Advocate, who is independent of the local IRS office and reports directly to the National Tax Advocate. Taxpayers can also contact the national Taxpayer Advocate Service at (877) 777-4778 or visit its Web site at www.irs.gov/advocate.

The Advocate must be satisfied that the taxpayer has been unable to get relief through usual IRS channels. If, as determined by the Advocate, the taxpayer is suffering or about to suffer a significant hardship as a result of IRS administration of laws, a TAO will be issued. A TAO may require the IRS to take any action permitted by law.

The TAO suspends the statute of limitations related to the subject of the order (for example, under IRC Section 6501 relating to the assessment or collection of tax) and immediately stops an IRS action or proposed action (such as a levy on the taxpayer's property). The period of suspension begins on the date of the taxpayer's application for a TAO and ends on the date of the Advocate's decision. Additionally, the Advocate can specify in the TAO any further suspension period.

Once a TAO has been issued, it is binding on the IRS unless revoked by the Secretary of the Treasury.

Form 911 is used to request the TAO, but the IRS says that a written statement will serve as well if the form is not available. The "significant hardship" described in the statute is defined as "more than an inconvenience to the taxpayer or a financial hardship, as such, but rather as a hardship from which the resultant disruption caused or to be caused to the taxpayer by the Internal Revenue Service's action or proposed action is such that it would offend the sense of fairness of taxpayers in general were they aware of all the surrounding facts and circumstances."

The Taxpayer Advocate must consider, among other things, the following four specific factors when determining whether there is a "significant hardship" and whether a TAO should be issued:

1. Whether there is an immediate threat of adverse action
2. Whether there has been a delay of more than thirty days in resolving the taxpayer's account problems

3. Whether the taxpayer will have to pay significant costs (including fees for professional representation) if relief is not granted
4. Whether the taxpayer will suffer irreparable injury, or a long-term adverse impact, if relief is not granted (IRC Sec. 7811(a)(2), as amended by the 1998 Act)

Significant hardships sometimes occur during IRS action to collect tax. Specific examples of hardships are

— Threat of a poor credit rating caused by erroneous enforcement action.

— Possible loss of employment.

— Pending eviction.

— Refusal of the IRS to rescind an erroneous statutory notice (ninety-day letter).

— Significant personal emergency, such as payment for medical treatment.

— Imminent bankruptcy.

— Inability to meet payroll.

The national Office of Taxpayer Advocate submits two reports to Congress annually. One lists goals for the coming year, and the second report lists the twenty most serious problems encountered by taxpayers and suggests ways for solving these problems.

13. TAX SHELTER DISCLOSURE REGULATIONS

On February 28, 2003, the IRS issued final regulations relating to tax shelters. Those regulations were substantially revised by the American Jobs Creation Act of 2004.

13.1 Disclosure Requirements

The rules governing disclosure are set forth in Treasury Regulation Section 1.6011-4, which generally apply with respect to transactions entered into on or after February 28, 2003. Under those rules, a taxpayer who "participates" in a "reportable transaction" is required to file a disclosure statement on IRS Form 8886 with respect to the transaction. A taxpayer is generally deemed to "participate" in a transaction if the taxpayer's federal income tax return reflects the tax treatment described

in a category of "reportable transaction." The following are the six categories of *reportable transactions*:

13.1.1 Listed transactions

A *listed transaction* is a transaction that is the same or substantially similar to a transaction that the IRS has determined to be a tax avoidance transaction and that the IRS has identified as a listed transaction by notice, regulation or other form of published guidance. For example, see Notice 2004-67.

The American Jobs Creation Act of 2004 extended the statute of limitations for assessment of any tax liability arising from a listed transaction until one year after the earlier of (1) the date on which the taxpayer makes the required disclosures, or (2) the date a material advisor satisfies the list maintenance requirements with respect to the transaction (see section 13.3).

13.1.2 Confidential transactions

A transaction is a *confidential transaction* if the taxpayer paid a minimum fee to an advisor of $250,000 in the case of a corporation, and $500,000 for most other taxpayers, if the taxpayer's ability to disclose the tax treatment or tax structure of the transaction is limited by any express or implied understanding or agreement, whether or not such understanding or agreement is legally binding.

13.1.3 Transactions with contractual protection

A transaction is a *transaction with contractual protection* if the taxpayer or a related party is entitled to receive a full or partial refund of fees if some or all of the intended tax consequences of the transaction are not sustained, or if the fees paid by the taxpayer are contingent on the taxpayer's realization of tax benefits from the transaction.

Additional rules regarding transactions with contractual protection are set forth in Rev. Proc. 2007-20.

13.1.4 Loss transactions

A transaction is a *loss transaction* if it results in the taxpayer claiming a loss under Code Section 165 in excess of the following thresholds:

- $10 million in any single year, or $20 million in any combination of taxable years, for C corporations and partnerships that have only C corporations as partners
- $2 million in any single year, or $4 million in any combination of taxable years for individuals, S corporations, trusts, and partnerships that do not have only C corporations as partners

- $50,000 in any single year for individuals or trusts if the loss arises in a Section 988 transaction (relating to losses from sales or exchanges of foreign currency), regardless of whether the loss flows through to such individual or trust from an S corporation or partnership

Additional rules regarding loss transactions are set forth in Rev. Proc. 2004-66.

13.1.5 Transactions with a significant book-tax differential

A transaction with a *significant book-tax differential* is a transaction in which the amount for tax purposes of any item or items of income, gain, expense, or loss from the transaction differs by more than $10 million on a gross basis from the amount of the item or items for book purposes in any taxable year. The rules regarding transactions with a significant book-tax differential only apply to:

- Taxpayers that are reporting companies under the Securities Exchange Act of 1934, and related business entities
- Business entities with gross assets of $250 million or more for book purposes at the end of any financial period that ends with or within the entity's taxable year in which the transaction occurs

Additional rules regarding transactions with a significant book-tax differential are set forth in Rev. Proc. 2004-67.

> ***Practice Note.*** Notice 2006-6 removed transactions with a significant book-tax differential from the list of reportable transactions covered by Treas. Reg. Sec. 1.6011-4, effective for transactions that would otherwise be reportable after January 5, 2006.

13.1.6 Transactions involving a brief asset holding period

A transaction *involving a brief asset holding period* is any transaction resulting in the taxpayer claiming a credit exceeding $250,000 (including foreign tax credits), if the underlying asset giving rise to the credit is held by the taxpayer for 45 days or less.

Additional rules regarding transactions involving brief asset holding periods are set forth in Rev. Proc. 2004-68.

13.2 Registration Requirements

Prior to the American Jobs Creation Act of 2004, Treasury Regulation Section 301.6111-2 required registration of certain confidential corporate tax shelters. The American Jobs Creation Act of 2004 replaced the

registration requirements with additional rules regulating tax shelters, as discussed below.

13.3 List Maintenance Requirements

The rules governing list maintenance requirements are set forth in Treasury Regulation Section 301.6112-1, which generally applies to any transaction that is a "potentially abusive tax shelter" entered into, or in which an interest was acquired, on or after February 28, 2003. Under those rules, a material advisor with respect to a transaction that is a "potentially abusive tax shelter" must comply with the list maintenance and disclosure requirements described below.

13.3.1 Material advisors

A person is a *material advisor* with respect to a potentially abusive tax shelter if the person is required to register the transaction (see section 13.2 above); or if the person receives or expects to receive a minimum fee with respect to the transaction (as described below) and the person makes a tax statement for the benefit of the taxpayer who is required to disclose the transaction (see section 13.1 above) and certain other persons.

The minimum fee referred to in the preceding paragraph is:

- $250,000 if every person to whom or for whose benefit the advisor makes a tax statement is a C corporation (or a partnership or trust of which all the owners are C corporations)
- $50,000 for all other transactions

The $250,000 and $50,000 minimum fees described above are reduced to $25,000 and $10,000, respectively, if the transaction is a listed transaction (see section 13.1.1 above).

A *tax statement* is any statement, oral or written, that relates to a tax aspect of a transaction that causes the transaction to be a reportable transaction (see section 13.1 above) or a confidential corporate tax shelter (see section 13.2 above).

13.3.2 Potentially abusive tax shelters

A transaction is a *potentially abusive tax shelter* if the transaction is required to be registered under Code Section 6111 (see section 13.2 above), regardless of whether or not it is properly registered, if the transaction is a listed transaction (see section 13.1.1 above), or if a potential material advisor knows or reasonably expects that the transaction will be a reportable transaction under any of the other five categories of reportable transactions discussed in section 13.1 above.

13.3.3 List maintenance and disclosure requirements

If a material advisor is required to maintain a list with respect to any potentially abusive tax shelter transaction, the list must include:

- The name of the transaction that is a potentially abusive tax shelter and the registration number, if any, obtained under Code Section 6111
- The taxpayer identification number (TIN), if any, for the transaction
- The name, address, and TIN of each person to whom (or for whose benefit) the material advisor makes or provides a tax statement
- The date on which each such person entered into the transaction, if known by the material advisor
- The amount invested by such person in the transaction, if known by the material advisor
- A detailed description of the tax treatment that such person is intended or expected to derive from participation in the transaction, if known to the material advisor
- A summary schedule of the tax treatment that such person is intended or expected to derive from participation in the transaction, if known to the material advisor
- Copies of any additional written materials, including tax analyses or opinions, relating to the transaction that are material to understanding of the purported tax treatment or tax structure of the transaction
- If the interest in the transaction was not acquired from the material advisor required to maintain the list, the name of the person from whom the list was acquired

The material advisor is required to maintain the list for seven years after the earlier of the date on which the material advisor last made a tax statement relating to the transaction, or the date on which the transaction was entered into. In addition, the material advisor is required to furnish the list to the IRS within 20 days after the IRS requests the list from the material advisor.

13.4 Additional Penalties and Sanctions

The American Jobs Creation Act of 2004 added a number of new sanctions and penalties that apply to tax shelter transactions including:

- A separate penalty for failing to disclose a reportable transaction (Code Section 6707A).

- An accuracy-related penalty that applies to understatements arising from listed and reportable transactions (Code Section 6662A).
- The denial of a deduction for interest on underpayments attributable to nondisclosed reportable transactions (Code Section 163(m)).
- A penalty for failing to provide tax shelter information required by Code Section 6111 (Code Section 6707).
- A revised penalty for failing to maintain investor lists (Code Section 6708(a)(1)).
- An increased penalty on promoters of abusive tax shelters (Code Section 6700(a)).

14. ALTERNATIVE DISPUTE RESOLUTION

Among the most promising methods for resolving disputes with the IRS are the many alternative dispute resolution (ADR) programs now offered by the IRS. The goal of the ADR programs is to resolve issues quickly. Based on early indications, ADR programs have been successful. As of May 31, 2003, 104 large and mid-sized business taxpayers successfully resolved issues through the Fast Track Settlement (FTS) program (see section 14.2.1 below), in an average time of 69 days. During the one-year period beginning June 2002, more than 200 cases have been mediated through the Fast Track Mediation (FTM) program (see section 14.2.2 below), with the parties resolving 100 percent of all open issues in more than half of those cases.

14.1 Pre-Filing Agreements (PFA)

The PFA program was established by the IRS as a pilot program pursuant to Notice 2000-12, and was made permanent by Rev. Proc. 2001-22. Rev. Proc. 2001-22 was superseded by Rev. Proc. 2005-12, which expanded the PFA program to include resolution of issues for future tax years. Rev. Proc. 2005-12, was superseded by Rev. Proc. 2007-17, which renewed the PFA program through 2008. The PFA program allows large and mid-sized businesses under the jurisdiction of the Large and Mid-Size Business Division of the IRS (LMSB) to resolve issues involving factual questions under well-settled principles of law prior to filing the taxpayer's return with respect to such issues. A taxpayer under the jurisdiction of the LMSB may request to participate in the PFA program with respect to the current taxable year or any prior taxable year for which the return is not yet due (including extensions) and has not yet been filed, and for the four succeeding taxable years.

Rev. Proc. 2007-17 sets forth a nonexclusive list of issues that are likely to be suitable for resolution through the PFA program, including:

- Issues that require either a determination of facts or the application of well-established legal principles to the facts.
- Issues regarding a methodology used by a taxpayer to determine the appropriate amount of an item of income, allowance, deduction or credit.

Rev. Proc. 2007-17 also sets forth an exclusive list of international issues that are likely to be suitable for resolution through the PFA program, and a nonexclusive list of issues that are not eligible for resolution through the PFS program, including:

— Transfer pricing issues

— Issues of reasonable cause, due diligence, good faith, clear and convincing evidence, or any other similar standard

— Issues involving the application of any penalty or criminal sanction

— Issues that have been designated for litigation by the IRS, or that are the subject of litigation between the IRS and the taxpayer for a prior taxable year

— Issues involving tax shelters

A taxpayer desiring to participate in the PFA program must submit a written request in accordance with the requirements described in Rev. Proc. 2007-17. The LMSB Industry Director with jurisdiction over the taxpayer will determine whether to accept the taxpayer's request based on certain criteria, including:

- The suitability of the issue presented for resolution through the PFA program
- The potential impact of a PFA resolution on other years or other issues of the taxpayer
- The time remaining until the due date of the taxpayer's return
- The likelihood of completing the PFA process prior to the due date of the taxpayer's return

If the taxpayer's request to participate in the PFA program is accepted by the LMSB Industry Director, the taxpayer must pay a user fee $50,000 for each separate and distinct issue. The taxpayer will then have one or more meetings with a representative from the LMSB at which the parties will work to resolve the issue. If the taxpayer and the LMSB representative are able to resolve the issue in a timely manner,

they will enter into a Pre-Filing Agreement that has the effect of a closing agreement under Code Section 7121.

The taxpayer may withdraw its request to participate in the PFA program at any time (although the user fee will generally not be refunded). If the taxpayer and the LMSB representative are unable to resolve any issue, the taxpayer will retain all of its rights with respect to the issue, including the right to attempt to resolve the issue through the post-filing resolution procedures described below.

14.2 Alternative Resolution at Examination

14.2.1 Fast Track Settlement (FTS)

The FTS program was established by the IRS as a pilot program pursuant to Notice 2001-67 and, based on the initial success of the program, was made permanent by Rev. Proc. 2003-40. FTS allows for mediation of examination issues facing large corporations under the jurisdiction of the Large and Mid-Size Business Division of the IRS (LMSB), with a goal of resolving such issues within 120 days after the issue is accepted into the FTS program. Under certain circumstances, other IRS divisions and taxpayers may participate in the FTS program.

Participation in the FTS program is voluntary. LMSB and the taxpayer may submit an issue to the FTS program after LSMB has issued a Form 5701 (Notice of Proposed Adjustment) with respect to the issue, and the taxpayer has responded to the issue in writing, but before LMSB has issued a Notice of Proposed Deficiency (i.e., a 30-Day Letter) with respect to the issue. The issue will be accepted into the FTS program only if the FTS program managers determine that the issue is sufficiently developed to permit resolution within the framework of the FTS program.

There are certain issues that are not eligible for inclusion in the FTS program, including:

- Issues designated for litigation
- Issues for which the taxpayer has requested competent authority assistance
- Issues that might result in inconsistent treatment for a party that is not participating in the matter, i.e., "whipsaw" issues
- Issues governed by closing agreements, *res judicata* or controlling precedent
- Issues that have been identified in a Chief Counsel Notice or equivalent publication as being excluded from the FTS program

If an issue is accepted into the FTS program, an Appeals Official will be assigned to act as a neutral-party mediator. The Appeals Official may also recommend a settlement based on his or her analysis of the issues. The taxpayer may withdraw the issue from the FTS program at any time, and is not bound to accept any settlement recommended by the Appeals Official. Participation in the FTS program does not eliminate the taxpayer's right to have an Appeals conference with respect to the issue, or any other rights of the taxpayer with respect to the issue.

The IRS announced in Announcement 2006-61 that the FTS program would be made available to taxpayers under the jurisdiction of the Small Business/Self Employed (SB/SE) division of the IRS on a trial basis.

14.2.2 Fast Track Mediation (FTM)

The FTM program, which was formally established by the IRS pursuant to Rev. Proc. 2003-41, provides a procedure similar to FTS for taxpayers under the jurisdiction of the Small Business/Self-Employed Compliance Division of the IRS (SB/SE). FTM is generally available for all non-docketed cases and collection matters under the jurisdiction of SB/SE, including offers in compromise, trust fund recovery penalty and collection due process cases. The goal of the FTM program is to resolve issues within 30 to 40 days after the initial mediation conference.

Participation in the FTM program is voluntary and may only be initiated at the conclusion of an examination/collection determination. There are certain issues and cases that are not eligible for inclusion in the FTM program, including issues that are not eligible for the FTS program (as discussed in section 14.2.1 above), and the following issues and cases:

- Issues for which there is an absence of legal precedent
- Issues for which there are conflicts between circuit courts of appeal
- Issues included in the Technical Advisor Program, the Appeals Technical Guidance Program, or the Collection Appeals Program
- Automated Collection System cases
- Frivolous issues
- Cases in which the taxpayer has failed to respond to IRS communications
- Certain issues involving methods of accounting

Similar to FTS, an Appeals Officer is assigned to act as a neutral-party mediator for FTM issues, and the Appeals Officer may recommend

a settlement based on his or her evaluation of the issues. The taxpayer or the IRS may withdraw an issue from the FTM program at any time, and the Appeals Officer may terminate FTM consideration of an issue if he or she concludes that the parties are not making meaningful progress toward resolving the issue. Participation in the FTM program does not eliminate the taxpayer's right to have an Appeals conference with respect to the issue, or any other rights of the taxpayer with respect to the issue.

14.2.3 Tax Exempt Bond mediation (TEB)

The IRS launched a Tax Exempt Bond Mediation Dispute Resolution Pilot Program. Similar to FTS and FTM, the TEB mediation program is designed to resolve cases under examination in the IRS Tax Exempt Bond organization in 60 days or less through the use of Appeals Officers acting as neutral-party mediators. The specifics of the TEB mediation program, and the procedure for initiating a request for mediation, are set forth in IRS Announcement 2003-36.

14.3 Alternative Resolution at Appeals

Code Section 7123, which was added to the Code by the Internal Revenue Service Restructuring and Reform Act of 1998, provides three alternative methods of resolving issues at the Appeals level.

14.3.1 Early referral to Appeals

Under Code Section 7123(a), the IRS is required to establish procedures by which any taxpayer can request that one or more issues under consideration by the examination or collection division of the IRS be referred to Appeals while other issues remain under consideration by the examination or collection division.

The procedures established by the IRS are set forth in Rev. Proc. 99-28, which provides that a taxpayer may request early referral to Appeals of any developed, disputed issue arising from audit under the jurisdiction of the District Director. The following issues, however, are excluded from the early referral program:

- Issues with respect to which a 30-day letter has been issued
- Issues that are not fully developed
- Issues arising during an audit if the remaining issues are expected to be resolved before Appeals can resolve the early referral issues
- Issues designated for litigation by the Office of Chief Counsel

- Issues for which the taxpayer has requested Competent Authority assistance, or intends to request Competent Authority assistance
- Issues that might result in inconsistent treatment for a party that is not participating in the matter, i.e., "whipsaw" issues

In order to request early referral of an issue, the IRS must first issue a Form 5701 (Notice of Proposed Adjustment) with respect to the issue. The taxpayer must respond to the Form 5701 in writing. The taxpayer's written response serves the same function as a "Protest" for purposes of consideration by Appeals.

If the taxpayer is able to resolve an early referral issue at Appeals, the parties will enter into a closing agreement pursuant to Code Section 7121 with respect to the issue. If the taxpayer is unable to resolve an early referral issue, the taxpayer may request mediation or arbitration with respect to the issue (see sections 14.3.2 and 14.3.3 below), but Appeals will not otherwise reconsider the issue.

Rev. Proc. 99-28 also sets forth special procedures for early referral of issues involving IRS initiated changes in accounting methods, employment taxes, collections matters, and employee plans and exempt organizations.

14.3.2 Nonbinding mediation

Under Code Section 7123(b)(2), the IRS is required to establish procedures by which either the taxpayer or the Appeals Officer may request nonbinding mediation of any issue that remains unresolved following the conclusion of Appeals procedures, or in the event of an unsuccessful attempt to enter into a closing agreement.

The procedures established by the IRS were initially set forth in Announcements 98-99 and 2001-9, which limited mediation to certain issues involving adjustments of $1 million or more. The Appeals mediation procedures were formally established by Rev. Proc. 2002-44, which expanded the issues eligible for mediation, and removed the $1 million limitation.

Under Rev. Proc. 2002-44, mediation is generally available for all legal and factual issues at issue before an Appeals Officer, except that mediation is not available for:

- Issues designated for litigation or docketed in any court
- Collections cases
- Issues governed by closing agreements, *res judicata,* or controlling Supreme Court precedent
- Frivolous issues (including the issues listed in Rev. Proc. 2001-41)
- Cases in which the taxpayer did not act in good faith during settlement negotiations

If a matter is accepted for mediation, the mediator will be an Appeals employee who is trained as a mediator. The taxpayer may also elect to have a non-IRS employee serve as a comediator, at the taxpayer's expense. Either the taxpayer or the Appeals Officer may terminate the mediation at any time. If the parties reach an agreement on some or all of the issues submitted to arbitration, the parties will enter into a closing agreement with respect to those issues. If the parties are unable to resolve any issue submitted to arbitration, the parties may submit the issue for binding arbitration (if available, as discussed in section 14.3.3 below). Otherwise, the IRS will issue a statutory notice of deficiency (i.e., a 90-day letter).

14.3.3 Binding arbitration

Under Code Section 7123(b)(2), the IRS is required to establish a pilot program under which the taxpayer and the Appeals Officer may jointly request binding arbitration of any issue that remains unresolved following the conclusion of Appeals procedures, or in the event of an unsuccessful attempt to enter into a closing agreement.

The procedures for the pilot program initially established by the IRS are set forth in Announcement 2000-4, which was effective for arbitration requests submitted during the two-year period beginning on January 18, 2000. In Announcement 2002-60, the IRS extended the test program for an additional one-year period beginning on July 1, 2002. The program was made permanent by Rev. Proc. 2006-44.

Arbitration must be requested jointly by the taxpayer and Appeals, after the taxpayer and Appeals have attempted to negotiate a settlement, and is available only for exclusively factual issues. Arbitration is not available for:

- Issues designated for litigation or docketed in any court
- Industry Specialization Program (ISP) issues or Appeals Coordinated Issues (ACI)
- Collection cases
- Issues governed by closing agreements, *res judicata,* or controlling Supreme Court precedent
- Frivolous issues
- Issues arising in cases where the taxpayer did not act in good faith during settlement negotiations

To participate in the binding arbitration program, the taxpayer must enter into an Agreement to Arbitrate (a model agreement is included in Announcement 2000-4). The arbitrator may be an Appeals representative, in which case the IRS pays all of the expenses associated

with the arbitrator, or may be a non-IRS arbitrator, in which case the IRS and the taxpayer share the expenses of the arbitrator. The decision of the arbitrator is binding upon the IRS and the taxpayer.

14.4 Binding Arbitration in Tax Court Cases

Tax Court Rule 124 provides that the parties to a Tax Court Case may move for binding arbitration of any factual issue in controversy at any time after the case is at issue and before the Tax Court trial. If the parties file a timely motion for voluntary binding arbitration, the Chief Judge of the Tax Court will assign the case to a Judge or Special Trial Judge for disposition of the motion and supervision of any subsequent arbitration in the case.

15. CIRCULAR 230

15.1 Background

As discussed in Section 2.3 of this chapter, Circular 230 sets forth rules governing practice before the Internal Revenue Service. The rules of Circular 230 generally apply to attorneys, accountants, enrolled agents and enrolled actuaries (referred to as "practitioners"). Section 822(a)(1) of the American Jobs Creation Act of 2004, which was enacted into law in October 2004, provides for censure and monetary penalties for practitioners who fail to comply with the provisions of Circular 230. As part of the IRS effort to combat abusive tax shelters, Circular 230 was substantially revised in December 2004 to provide a statement of best practices for tax advisors, rules governing the rendering of "covered opinions" by practitioners and rules governing other written advice provided by practitioners. Those rules, which have been a source of controversy and concern for practitioners, became effective on June 20, 2005.

15.2 Best Practices for Tax Advisors

Circular 230 provides a statement of best practices that practitioners should follow when advising clients and in preparing or assisting in the preparation of submissions to the IRS. The statement of best practices is aspirational, and there are no penalties imposed for violating the best practices. Best practices include:

- Communicating clearly with the client regarding the terms of engagement.
- Establishing the facts and determining which facts are relevant.

- Evaluating the reasonableness of any assumptions or representations.
- Relating the applicable law (including potentially applicable judicial doctrines) to the relevant facts.
- Arriving at a conclusion supported by the law and facts.
- Advising the client of the conclusions reached and the significance of the conclusions (for example, whether the client can avoid accuracy-related penalties by relying on the advice).
- Acting fairly and with integrity in practice before the Internal Revenue Service.

Tax advisors who are responsible for overseeing a firm's practice are required to take reasonable steps to ensure that a firm's procedures for all members, associates and employees are consistent with the "best practices."

15.3 Definition of Covered Opinions

The most significant provision introduced by the revisions to Circular 230 are new requirements for "covered opinions" issued by practitioners. A covered opinion is written advice (including e-mail) issued by a practitioner concerning one or more federal tax issues and relating to a transaction described in one or more of the following categories (each of which is discussed below):

- Listed transactions
- Principal purpose transactions
- Significant purpose transactions

A "federal tax issue" is a question concerning the federal tax treatment of an item of income, gain, loss, deduction or credit, the existence or absence of a taxable transfer of property, or the value of property for federal tax purposes.

15.3.1 Listed transactions

A "listed transaction" is a transaction that is the same or substantially similar to a transaction that the IRS has determined to be a tax avoidance transaction and that the IRS has identified as a listed transaction by notice, regulation or other form of guidance. See, *e.g.*, Notice 2004-67. See also Section 13.1.1 of this chapter.

15.3.2 Principal purpose transactions

A transaction is a "principal purpose transaction" if it involves any partnership or other entity, any investment plan or arrangement, or

any other plan or arrangement, the principal purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code. The "principal purpose" of an entity, plan or arrangement is the avoidance or evasion of tax if that purpose exceeds any other purpose.

15.3.3 Significant purpose transactions

A transaction is a "significant purpose transaction" if it involves any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, a significant purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code. Written tax advice relating to a significant purpose transaction is a covered opinion only if the written advice is:

- a "reliance opinion";
- a "marketed opinion";
- subject to "conditions of confidentiality"; or
- subject to "contractual protection."

15.3.3.1 Reliance opinions

A "reliance opinion" is written advice that concludes at a confidence level of more likely than not (*i.e.*, a greater than 50% likelihood) that one or more "significant tax issues" would be resolved in the taxpayer's favor. A federal tax issue is "significant" if the IRS has a reasonable basis for a successful challenge and its resolution could have a significant impact, whether beneficial or adverse and under any reasonably foreseeable circumstance, on the overall federal tax treatment of the transactions or matters addressed in the written advice.

> ***Practice Tip.*** The requirement that written advice must address a "significant tax issue" in order to be a covered opinion should prevent written advice on routine tax issues from being considered a reliance opinion.

Written advice will not be treated as a reliance opinion if the practitioner prominently discloses in the written advice that it was not written to be used, and cannot be used, for the purpose of avoiding penalties. An item is "prominently disclosed" if it is readily apparent to the reader which, at a minimum, means that the item set forth in a separate section (not in a footnote) in a typeface that is the same size or larger than the typeface of any discussion of facts or law in the written advice. This "disclosure exception" has led practitioners to routinely include disclosures on all written advice issued to clients. For example, many practitioners have set up their e-mail to automatically include a

"Circular 230 disclaimer statement" on every e-mail. Appendix 3 contains samples of Circular 230 disclaimer statements currently used by practitioners (see *Accountant's Business Manual Toolkit CD-ROM*).

15.3.3.2 Marketed opinions

A "marketed opinion" is written advice that the practitioner knows or has reason to know will be used or referred to by a person other than the practitioner (or a person affiliated with the practitioner) in promoting, marketing or recommending a partnership or other entity, investment plan or arrangement to one or more taxpayers. Written advice that does not address a listed transaction or a principal purpose transaction will not be treated as a marketed opinion if the practitioner prominently discloses in the written advice that

- the advice was not intended or written by the practitioner to be used, and cannot be used, for the purpose of avoiding penalties;
- the advice was written to support the promotion or marketing of the transaction or matter addressed in the written advice; and
- the taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

15.3.3.3 Conditions of confidentiality

Written advice is subject to "conditions of confidentiality" if the practitioner imposes on one or more recipients of the written advice a limitation on disclosure of the tax treatment or tax structure of the transaction, regardless of whether the limitation on disclosure is legally binding.

15.3.3.4 Contractual protection

Written advice is subject to "contractual protection" if the taxpayer has the right to a full or partial refund of fees paid to the practitioner (or paid to a person associated with the practitioner) if all or part of the intended tax consequences from the matters addressed in the written advice are not sustained, or if the fees paid to the practitioner are contingent on the taxpayer's realization of tax benefits from the transaction.

15.3.4 Exclusions

The following are not covered opinions:

- oral advice;
- written advice that does not resolve a federal tax issue in the taxpayer's favor (*i.e.*, negative tax advice), but not if the practitioner reaches a

conclusion favorable to the taxpayer at any confidence level (*e.g.*, not frivolous, realistic possibility of success, reasonable basis or substantial authority) with respect to that issue;

- written advice provided to a client during the course of an engagement if the practitioner is reasonably expected to provide subsequent written advice to the client that satisfies the requirements for a covered opinion;
- written advice (other than in connection with a listed transaction or a principal purpose transaction) that
  - concerns the qualification of a qualified plan;
  - is a state or local bond opinion; or
  - is included in documents required to be filed with the U.S. Securities and Exchange Commission;
- written advice prepared and provided after a taxpayer has filed a return with respect to an item on the return (but not if the practitioner knows the advice will be relied upon to take a position on a tax return—*i.e.*, an amended return); and
- written advice provided to an employer by a practitioner in that practitioner's capacity as an employee of the employer solely for purposes of determining the tax liability of the employer.

15.4 Requirements for Covered Opinions

A practitioner providing a covered opinion must comply with the requirements of Circular 230 with respect to

- factual matters;
- relation of law to facts;
- evaluation of significant federal tax issues;
- overall conclusion; and
- required disclosures.

15.4.1 Requirements regarding factual matters

To comply with the requirements of Circular 230 regarding factual matters, a practitioner must

- use reasonable efforts to identify and ascertain the facts, and to determine which facts are relevant;
- not base the opinion on any unreasonable factual assumption;
- not base the opinion on any unreasonable factual representations, statements or findings of the taxpayer or any other person.

The requirements regarding factual matters potentially pose the greatest challenge to a practitioner who wants to issue a covered opinion by essentially imposing a due diligence obligation on the practitioner with respect to the underlying facts of the client's transaction.

15.4.2 Requirements regarding relation of law to facts

To comply with the requirements of Circular 230 regarding relation of law to facts, a practitioner must

- relate the applicable law (including potentially applicable judicial doctrines, such as substance over form, step transaction, etc.) to the relevant facts;
- not assume the favorable resolution of any significant federal tax issue or otherwise base the opinion on any unreasonable legal assumptions, representations or conclusions; and
- avoid internally inconsistent legal analyses or conclusions.

15.4.3 Requirements regarding evaluation of significant federal tax issues

To comply with the requirements of Circular 230 regarding evaluation of significant federal tax issues, a practitioner must

- consider all significant federal tax issues;
- provide the practitioner's conclusion as to the likelihood that the taxpayer will prevail on the merits with respect to each significant federal tax issue considered in the opinion; and
- not take into consideration the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be resolved through settlement if raised.

15.4.3.1 Additional requirements for marketed opinions

In the case of a marketed opinion, the practitioner must conclude, at a level of confidence of at least "more likely than not," that the taxpayer will prevail on the merits. If the practitioner is unable to reach that conclusion, the practitioner may not issue the opinion without the disclaimer language described in Section 15.3.3.2 above.

15.4.3.2 Exception for limited scope opinions

A practitioner may issue an opinion that considers less than all of the significant federal tax issues raised by a transaction if

- the practitioner and the client agree that the scope of the opinion, and the client's ability to rely on the opinion to avoid penalties, will be limited to the matters addressed in the opinion;
- the opinion is not a marketed opinion and does not relate to a listed transaction or a principal purpose transaction; and
- the opinion contains the required disclosures discussed in Section 15.4.5.3 below.

15.4.4 Requirements regarding overall conclusions

To comply with the requirements of Circular 230 regarding overall conclusions, a practitioner must provide the practitioner's overall conclusion as to the likelihood that the federal tax treatment of the transaction or matter described in the opinion is the proper treatment, and the reasons for that conclusion.

15.4.5 Required disclosures

A covered opinion must contain all of the following disclosures that are applicable to such opinion.

15.4.5.1 Relationship with promoter

The opinion must prominently disclose the existence of any compensation, referral fee or fee-sharing arrangement between the practitioner and any person promoting or marketing the entity plan or arrangement that is the subject of the opinion.

15.4.5.2 Marketed opinions

In the case of a marketed opinion, the opinion must prominently disclose that

- the opinion was written to support the promotion or marketing of the transaction or matter that is the subject of the opinion; and
- the taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

15.4.5.3 Limited scope opinions

In the case of a limited scope opinion (as discussed in Section 15.4.3.2 above), the opinion must prominently disclose that

- the opinion is limited to the one or more federal tax issues addressed in the opinion;
- additional issues may exist that could effect the federal tax treatment of the transaction or matter that is the subject of the opinion; and

- the opinion was not written, and cannot be used, to avoid any penalties that may be imposed on the taxpayer with respect to any significant tax issue that is outside the scope of the opinion.

15.4.5.4 Opinions that do not reach a more-likely-than-not conclusion

If the practitioner does not reach a conclusion of more-likely-than-not with respect to a significant federal tax issue, the opinion must disclose that

- the opinion does not reach a conclusion of more-likely-than-not with respect to one or more significant federal tax issues; and
- the opinion was not written, and cannot be used, to avoid any penalties that may be imposed on the taxpayer with respect to such issues.

See Appendix 4 for a chart of categories, descriptions, and exceptions for adequate disclosures with regard to covered opinions (see *Accountant's Business Manual Toolkit CD-ROM*).

15.5 Procedures to Ensure Compliance

Practitioners who have principal responsibility for overseeing a firm's practice of providing tax advice must take reasonable steps to ensure that the firm has adequate procedures in place so that written tax advice rendered by the firm will comply with the rules applicable to covered opinions. A practitioner who fails to establish such procedures may be subject to discipline if individuals who are members of or associated with such firms engage in a pattern or practice that does not comply with the rules applicable to covered opinions.

15.6 Requirements for Other Written Advice

A practitioner must not give written tax advice (including e-mails), regardless of whether such written advice constitutes a covered opinion, if the practitioner

- bases the written advice on an unreasonable factual or legal assumptions;
- unreasonably relies on representations, statements or agreements of the taxpayer or any other person;
- fails to consider all relevant facts; or
- takes into account the possibility that a tax return will not be audited, or that an issue will be settled.

15.7 Conclusion

One impact of Circular 230 is the routine use of disclaimer language on all written correspondence issued by practitioners, with the result that, except in the rare occasion that a client specifically requests (and agrees to pay for) a covered opinion, clients can no longer rely on written advice from tax professionals to avoid penalties. The IRS is aware of this issue and has promised additional guidance in the near future to limit the broad scope of the covered opinion rules. Indeed IRS officials have suggested that the IRS may significantly revise the rules of Circular 230 applicable to covered opinions.

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Business Performance Measures

BUSINESS PERFORMANCE MEASURES

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1. PERFORMANCE MEASUREMENT DEFINED

1.1 Definition

Performance measurement is a consistent long-term process used to create wealth and return on investment in a business. It is an organized process of linking desired future performance with current information that is predictive of logical and consequential results. Key to performance measurement is the identification of critical success factors that lead to measures that can be tracked over time. The process includes evaluation of progress made in achieving specific targets linked to a business's strategic goals.

The measures track aspects of the entire business—both financial and nonfinancial (for example, customer satisfaction, product quality, sales calls, and proposals delivered). By focusing on key performance indicators, management will be able to stay on course with the business's strategy and more easily determine its overall performance.

Performance measurement is as pertinent to a small business as it is to a large business. In larger businesses, performance measurement involves leadership, operational managers, department supervisors, and rank and file workers. It communicates the business's goals and strategies to employees at all levels of the organization. The use of performance measures also allows companies to provide a clear link between compensation and performance and can be used as a means to motivate employees.

Performance measures have a direct correlation to company goals and serve as leading (future-oriented) indicators rather than the usual lagging-indicators (for example, last quarter's income or revenues).

1.2 Dynamic Forces Affecting a Business's Value

Particularly in small businesses, the value of the business is often tied more directly to the personal services of the owner than the intrinsic value of the business processes. Engrossed in constantly doing the work of the business, such proprietors rarely succeed in building businesses that can function independent of them in a completely predictable manner. Most lack the systems and performance measures that build a business's value.

The ultimate value of a business typically will be directly proportional to the owner's success in developing a business built on systematized processes. Where systems are in place for all processes, owners

do not have to do each process personally because they can rely on others less skilled. A business where everything is systematized becomes a "franchise prototype" which, if desired, could be duplicated time after time with completely predictable and reliable results. Of course, franchising their business would not fit the mission statement of most business owners. Yet, every small business owner should approach his or her business with the end in mind and approach each decision with the goal of creating wealth through a business of value that can be sold or transitioned to a successor without the continuing involvement of the owner.

Increasing the value of a business can generally occur only when management addresses the four most common ways in which profitability is created: (1) increasing the number of customers, (2) increasing the frequency of sales to those customers, (3) increasing the average value of each sale, and (4) increasing the effectiveness of each business process. Business performance measures assist the owner in managing the effectiveness of each system, and ultimately the total value of the business.

2. EVALUATING THE NEED FOR PERFORMANCE MEASURES

2.1 Critical Success Factors

The success of each business is built upon the strength of those factors that it must do perfectly, time after time. The performance measurement process helps businesses determine those factors and build a process for measuring and evaluating the effectiveness of each business process. Many, if not most, small businesses fail to achieve their potential profitability because they lack a structured process for measuring, testing, and evaluating the aspects of their business that they must get absolutely right.

2.2 Entrenchment in the Status Quo

Businesses generally cannot become successful by predetermining what the marketplace wanted. The statement "Build it and they will come" might apply to baseball diamonds in cornfields but not to entrepreneurship. Every aspect of a successful business must be constantly measured and tested against the marketplace. This applies to all areas of the business, including advertising campaigns, guarantees, product packaging, and pricing.

2.3 Management Self-evaluation

For a business to successfully implement a performance measurement process, the leadership must be fully behind the process. Embarking on this initiative requires a significant level of time, energy, and resources reallocated to the process. Management should evaluate its own commitment to the performance measurement process by considering the following issues:

— What aspects of the business does management worry about?

— Is there pressure to improve cash flow or net income?

— Are owners or creditors discontented with recent results?

— How committed is the leadership to embracing change?

— What type and level of leadership are leading this initiative? Do they work?

— Which level of management has participated in planning similar changes in the past?

— How have past efforts at enacting change succeeded?

— Where will the resistance to change most likely erupt?

— Will upper management show outward and ongoing support for the initiative?

— Who are the identifiable champions?

— Is there evidence of adopting new measurement tools in the past?

— Has previous strategic planning been done?

— What level of support exists among the board of directors?

2.4 Commitment to Change

Getting commitment from the rank and file employees for the business performance measurement process cannot happen without the leadership making a strong statement of purpose. Commitment can crumble as daily workloads direct attention away from the process. Such a statement of purpose should be repeated often to continue motivating team members toward the common goals. A business embarking on a new initiative for performance measurement should appoint a "champion" or "sustainer," one who will ensure managers and employees implement the changes and new systems required by this reengineering. See section 8.4 of this chapter for more information.

2.5 Building on Previous Strategic Plans

A business that has previously invested in developing a strategic plan should review and evaluate where the company stands in relation to the goals and objectives of that plan. The review should occur at least annually. Consistent, steady progress toward those strategic goals should be noted. A new strategic planning session is appropriate either when the company has achieved the majority of those previously set goals or when the efforts have stalemated. Refer to the chapter "Business Plans" for more information on long-range planning.

CPA Performance View Services: A Practitioner's Guide to Providing Performance Measurement Engagements (New York: AICPA, 2000) is a set of tools to assist an independent consultant in implementing a business performance measurement system for small business clients. Appendix 1 of this chapter contains a questionnaire suitable for businesses or their consultants to assess their readiness to embark on the performance measurement process.

3. HISTORICAL ASSESSMENT

3.1 Establishing a Baseline

Assessment of a company's current truths is an essential element in establishing performance measures. An honest assessment of performance, quality, customer loyalty, competitive market share, inventory turnover, and business valuation is critical for a solid basis for later decisions. Staff with skills in data acquisition, research, analysis, engineering, and human resources should be part of the assessment team. All aspects of the business's past performance should be included in the evaluation, including financial, operations, human resources, customers, and vendors.

Previous planning documents are very helpful in establishing a baseline. These would include long-range strategic plans, cyclical reviews of facilities needs and capital investment, annual budget and operating plans, staffing and human resource plans, and business succession plans. Other documents useful in establishing baseline information include employment history of key employees, past audit findings, system documentation and the employee handbook. Appendix 2, which contains a checklist for planning documents and existing or prior consulting relationships, can assist a business in assembling this information.

3.2 Vision Statements

An organization's vision statement consists of its core values and beliefs, a statement of purpose, and a statement of mission. A well-drafted vision statement does not significantly change over time and should convey what the business will look like several years in the future.

In addition, the vision needs to be realistic and attainable and appeal to the long-term interests of owners, employees, and customers. It should be focused enough to guide decisions, yet be flexible to allow individual interpretation and initiative. It needs to be clear enough that it can be explained and understood by every person in the business, from CEO to custodian. Finally, the vision must make strategic sense and be measurable in its key elements.

In creating a new vision statement, leadership should picture the company five years hence. The business should be described in terms of its potential structure and key people. Describe the customer base in terms of the number, type, and location of customers. Estimate the level of future revenue and profitability desired in five years. What major products or services are envisioned? What type of facilities and technology would be needed to support the organization? What human resources are needed?

3.3 Mission Statements

A mission statement flows from the vision statement by describing in the present tense why a business exists, whom it serves, and how it intends to accomplish its purpose. A mission statement should indicate the major products or services offered and the company's market position. The business philosophy and core values should be clearly and concisely stated. Mission statements should be updated on a regular basis as the company's products and markets evolve.

3.4 Strengths, Weaknesses, Opportunities, and Threats Analysis

A strengths, weaknesses, opportunities, and threats (SWOT) analysis can be used in preparing the company's mission statement, by assisting in developing its underlying support. SWOT looks at a business through its strengths and opportunities, which are helpful in achieving the overall objectives, and weaknesses and threats, which are harmful to achieving those objectives. Strengths and weaknesses are internal attributes of an organization. Management has control over each and every

strength and weakness. Opportunities and threats, however, are external conditions not readily controllable by management.

For example, opportunities include such issues as new markets opening up for the company or access to new products or services. Threats would be competitors or government legislation that can adversely affect industries.

A SWOT analysis may be conducted for individual aspects of the business, such as financial, operations, human resources, customers, and vendors. Information for SWOT analyses can come from many internal and external sources. Consider the sales history, customer surveys, market surveys, feasibility studies, trade associations, government publications, employee surveys, and competition studies.

An issue may appear as both a strength and a weakness, in different points of a company's life cycle. Door-to-door sales may have been a strength in the past because of the customer convenience. However, technological advances could turn this into a weakness as more customers engage in electronic commerce (e-commerce). In this instance, the business is being viewed from the past or the future rather than the present. A SWOT analysis should focus strictly on what it is today.

The following chart contains listings of various strengths, weaknesses, opportunities, and threats that should be considered in a typical SWOT analysis. They are categorized to assist in defining attributes into categories that are within or outside management's control.

3.5 Life Cycle Analysis

Life cycle analysis looks at the company's maturity through the classic bell curve. In every organization, some aspects of the operation, product or market are moving through start-up, growth, maturity or declining stages. Characteristics that are in the declining stages may need to undergo reengineering to revitalize, bringing them back to a start-up stage. Information from a life cycle analysis is helpful in conducting the SWOT analysis.

3.6 External Assessments

Some valuable information is typically available only outside the organization. Convening a customer advisory board can provide objective feedback on how others perceive the organization's effectiveness in delivering customer relations, service support, product guarantees, and the relative value of its products or services in relation to competitors.

Customer advisory boards may consist of focus groups or ad hoc panels, meeting with an independent facilitator to elicit honest feedback.

Strengths and weaknesses	Opportunities and threats
Revenue and sales	*National and local economy*
Product and services pricing	Economic growth forecasts
Customer satisfaction	Incremental borrowing rate
Excess sales capacity	Consumer disposable income
Growth prospects	*Competition*
Competitive market share	Quality of products and services
Profitability	Pricing policies
Marketing plan	Customer satisfaction
Personnel	Market share
Experience and expertise	*Technology*
Continuing education and job training	Obsolescence due to new technology
Utilization of workforce	*Population trends*
Employee motivation and morale	Demographics of population
Frequency of staff meetings	Amount of leisure time available
Outside management consultants	Standard of living
Facilities	*Environmental/legal issues*
Efficiency of facilities	Environmental preservation
Productivity of equipment	New legislation
Availability of capital	Legal case law
Inventory and purchasing management	Natural disasters
Working capital	
Cash flow	
Availability of credit	
Timeliness, reliability and availability of financial information	
Present measurement of key performance indicators	
Accounts receivable collections	

3.7 Employee Reward Structure

Employees will do more of the things for which they are rewarded. A study of the current compensation structure can give insight into the behaviors that are currently being rewarded. For example, management can stress at great length the need for new, creative ideas from employees. But this behavior may not occur to any extent if employees are rewarded for completing low level, routine tasks (and perhaps penalized for diverting attention toward other activities). Employee compensation and benefits should be structured around the performance measures designed to achieve the overall business objectives.

4. CRITICAL SUCCESS FACTORS

4.1 Attributes

Critical success factors (CSFs) are those things that a business must get absolutely right to be successful. They are essential elements for accomplishing what the organization has stated in its vision and mission statements.

4.2 Selecting Appropriate CSFs for the Organization

Critical success factors should come from each of the key performance areas of an organization: Financial, operations, human resources, customers, and vendors. In selecting CSFs, consider the differences between outputs and outcomes. Outcomes are generally closer to the end results that are being measured, such as "increased customer loyalty." Outputs, on the other hand, are components of a value chain that integrate into subsequent activities, such as "100 percent on-time delivery." Appendix 3 contains a flowchart describing the relationship between inputs, processing systems, outputs, outcomes, and goals.

CSFs should consider the performance attributes that the organization's customers monitor. Customers often have clear and explicit requirements of their vendors. A survey or client advisory board can help determine the variables that other companies monitor.

Examples of typical critical success factors include:

— Management succession plan

— High customer satisfaction rating

— Timely accounts receivable collection

— Increased inventory turnover

— Debt to equity ratio under 2:1

— Increased revenue per salesperson

4.3 Developing a "Short List" of CSFs

An organization should work with a manageable number of CSFs (perhaps six to twelve). The CSFs need to be intuitively understood by the rank and file employees to gain acceptance, particularly if a factor is within an employee's sphere of influence.

Critical success factors should address both short- and long-term aspects of the organization. Selecting CSFs with a short-term focus will

enable the company to achieve some early gains in its reengineering process, thus sustaining the momentum and enthusiasm of the team. Restructuring some aspects of the organization will certainly encompass multiple years.

Attention should be focused on those factors that will most positively affect the organization's results. A long list of possible CSFs can be narrowed down by having the planning team members each rate the CSFs in order of their significance. A paired comparison exercise (deciding the most important of any two items) can quickly reduce a large number of CSFs to a manageable short list.

4.4 Relevance to Vision and Mission Statements

The critical success factors chosen by management should relate directly to the vision and mission statements. The CSFs should build on the strengths identified in the SWOT analysis, leveraging those strengths to take advantage of the competitive landscape. Where the SWOT analysis has identified weaknesses that could be exploited by competitors, a CSF should address this.

5. KEY PERFORMANCE INDICATORS

5.1 Quantifying Specific Changes in Performance

Specific changes in performance can be quantified through key performance indicators (KPIs). KPIs may be either financial or nonfinancial. KPIs must be easily understandable to inspire team members to work toward a specific target or attribute. KPIs should have little or no chance of producing an erroneous reading and should give the same reading consistently given the same operating conditions. The selected KPIs should be timely and frequently reported and be easily obtained from the reporting systems currently in place. Last, they should be measurable against a benchmark.

Following are examples of KPIs typically monitored in a professional services business:

- Work-in-process (WIP) aging
- Accounts receivable aging
- Write-offs as a percentage of WIP added

- Average hourly billing rate realized
- Actual versus budgeted charge hours by employee on a monthly basis
- Actual versus budgeted charge hours for the firm as a whole on a monthly basis
- Utilization ratio of hours billed divided by total available hours
- Average fees per client, actual versus budget
- Ratio of fees from top 20 percent of clients to total fees
- Fees from one-time engagements as a percentage of total fees collected
- Fees from each service area as a percentage of total fees and comparison to budget
- Ratio of fees billed to employee salary and benefits (individual and whole firm)
- Average annual fees from new clients
- Average annual fees from clients lost
- Ratio of fees won to fees lost
- Conversion ratio of new clients gained to proposals prepared
- New client referral sources

It is important to measure the activity that produces the result, not simply the result. While increased sales levels may be a result, the activity leading up to sales consists of number of contacts made with customers, rates of conversion of contacts into sales, frequency of sales with a particular customer, and the average dollar amount of each sale. Appendix 4 contains a sample work plan for establishing KPIs in a local public accounting firm.

5.2 Giving Feedback

Different people within an organization require different levels of feedback. The performance measurement reporting system design should give different user groups the information that is useful to their department. From inquiries of these users, an organization can determine if the KPIs will be used in decision making, compliance, work direction, process controls, or resource management.

5.3 Relating Key Performance Indicators to CSFs

Grouping CSFs into performance areas provides a balanced approach to performance measurement. Performance areas might include employee

satisfaction, supplier performance, operational performance, products and services, customer satisfaction, and financial performance.

Not all CSFs require immediate measurement because some will be integrated into meaningful measurements at a step later in the value chain. To simplify the information required, organizations should begin with narrow, company-specific measures to monitor intermediate steps in the value chain. As the organization gains experience in performance measurement, external measures can be added, such as monitoring the level of product endorsements or outside recognition.

5.4 Predictive and Leading Factors

Traditional accounting systems are rooted in historical information on where an organization has been. Nonfinancial factors can lead toward meaningful predictions of where a company's performance is headed in the foreseeable future. Nonfinancial factors that predict future profitability can include:

— Conversion rates of proposals into sales orders

— Market share and strength of market position

— Customer loyalty

— New product development

— Quality of management team

Focusing on leading indicators, rather than historical results, allows an organization to anticipate and correct negative results by observing its early warning signs. Leading indicators tell management what will happen downstream in the value creation process.

5.5 Benchmarking to Industry Measures

Benchmarking is the process of evaluating key performance indicators against an internal or external target. Industry-wide benchmarks give the organization an indication of how its efficiency and results compare to those of its competitors.

In many industries, data warehouses provide a pool of information shared by a group of companies. Within the pool, individual identification is lost, thus preserving confidentiality and anonymity. These targets allow an organization to set high performance targets, such as achieving performance in the top quartile of industry competitors. Industries that have many manufacturers of generic commodities, such as agricultural production, have led the way in establishing data pools for industry-wide benchmarking.

Industry trade associations often provide useful industry benchmarks. The Risk Management Association (RMA) publishes standards of financial performance compiled from statistically reliable samples of companies in the United States. Internet search engines can also be used to locate and access the wealth of information available online.

In certain circumstances, it may be more appropriate to use internal benchmarks because of the unique position of the company within its industry. However, internally set benchmarks might not stretch the company to achieve high standards of excellence. Many times, looking to another industry for relevant benchmarks is preferable to internal benchmarks.

5.6 Data Gathering and Reporting

The process of gathering data for performance measurement includes identifying the individual owners of the measures. Depending on the measurement factor, this could be an individual, team, or department. One should consider the desired frequency of measurement and develop templates for gathering and reporting that integrate with other measures.

Several software packages exist for performance measurement analysis. *CPA Views,* software developed by the American Institute of Certified Public Accountants in partnership with PerformanceSoft™, was designed specifically to help CPAs addresss management needs for establishing new standards, systematically measuring progress, and monitoring an organization's results compared with earlier performance.

It provides templates for planning input and outcomes. The software includes easy-to-understand measurement tools that can be customized precisely to an organization's needs. The software also features wizards and a graphic display package and allows users to drill down through the performance measurement system in progressive levels of detail. The software captures information at varying levels of detail for key functional or performance areas of the organization. More information is available at www.aicpa.org.

6. FINANCIAL RATIOS

Ratio analysis, in particular, may be undertaken to help a client evaluate past, current, and future performance. A ratio is by itself meaningless until it is compared to prior years, projections, and industry averages, as well as to other ratios. The benefit of ratio analysis is that it provides

a benchmark for measuring performance, targeting future goals, and helping identify potential problem areas.

The financial ratios presented in Appendix 5 may be useful in many different types of client engagements. Those ratios selected for presentation in this section represent only those commonly used in credit or comparative analysis. The term *comparative* is used to refer to the financial data of similar entities or to industry data. Such data may be obtained from a variety of sources. See the chapter "Business Valuation" for a comprehensive list of industry sources.

7. PERFORMANCE TARGETS

7.1 Range of Desired Outcomes

Most performance targets are best defined as a range, rather than a specific amount, for the desired outcome. In setting ranges for outcomes, use logical measures. An independently owned franchise should certainly set targets within the franchiser's requirements for continued product licensing. However, companies that have historically operated far below their peer groups should not set performance targets in the top quartile.

Time-sensitive measures will assist in driving improved value and performance where they anticipate and predict future outcomes. Measures should be linked to the organization's annual plan for planning and periodic review. Seasonal variances need to be considered so that ranges of acceptable outcomes are appropriate for that time of year. This is especially important where mid-year reviews are customary. Year-end reviews can be helpful in providing a springboard for the next year's annual planning activities.

Progress points need to be placed early enough to allow time to address substandard performance. For example, if high absenteeism leads to poor workmanship, high levels of rework, and poor billing realization, the time for measures must be early enough to build in response times. Measurements should be placed far enough apart to allow performance improvements to be apparent in the production process.

7.2 Selecting Achievable and Appropriate Targets

Organizations need to see early gains to maintain momentum and across-the-board acceptance of reengineering initiatives. If targets are

set too high, failure to achieve the initial targets can translate into resentment and resistance. On the other hand, targets set too low provide little motivation to improve performance areas. Rank and file employees should have a strong voice in selecting targets so they assume ownership and responsibility for achieving targets.

Moving in gradual steps away from the historical performance of the recent past lessens the likelihood of internal resistance resulting from early failures where targets are set too high.

7.3 Defining Performance Standards

As standards for performance are established, they need to be defined in terms that employees or vendors can easily understand. Each work group or team in the company should establish its own performance standards. Performance standards cover all aspects of a business, not just financial or production control.

For example, in customer relations the performance standards may address such things as:

— How will telephones be answered? Are calls screened? When can a customer expect a return phone call?

— How are customers greeted? What language is acceptable and how formally are customers addressed?

— How will customers be assisted? Will they be escorted to a requested area rather than pointing?

— How will complaints be handled? Do employees who receive complaints "own" them and are they responsible for the customer's satisfaction even if it is outside of their area?

Even such intangible areas as customer relations can establish performance measures to assess the effectiveness in carrying out the team's performance standards.

8. ACTION PLANS

8.1 Setting Accountability

Action plans ensure that priorities are set in every area of your business, from marketing and operations to management, personnel, and finance. They focus management's attention on the long-term objectives of the business rather than just the urgent day-to-day crises. The plan

defines the specific short-term objectives that will lead the business to that long-term future.

For each action, the plan should identify the:

- Activity
- Responsible party
- Key performance indicator
- Timetable
- Resources needed and budget

For an action plan to succeed, ultimate responsibility for each task should rest on just one person. While more than one person may actually complete a task, sharing the responsibility for its completion increases the likelihood of miscommunication and inaction. An effective rule of thumb is that if more than one person is responsible, no one is responsible.

8.2 Team-based Accountability

Team-based accountability is a powerful motivator in shaping behavior to achieve desired outcomes. Teams produce more predictable, consistent performance than individual workers because the team establishes the norms that all members are expected to attain.

8.3 Developing and Integrating Action Plans

Each work unit should be involved in developing its own action plans so members take ownership in achieving the goals of improving business performance. When each team has developed a draft action plan, the planning team should evaluate and compare the plans to ensure they are compatible and address the right performance measures. Systems need to be implemented to allow reporting of new measures and relationships as identified on the action plans.

8.4 Failure to Implement Action Plans

A common occurrence among small businesses is receiving an action plan from a business consultant as the result of an in-depth systems consulting engagement and then failing to implement the recommendations. The early excitement from the potential for change gives way to the day-to-day crises and emergencies. From the top down, employees put off the action plan and become consumed by the urgent yet unimportant matters of the day.

Appoint a champion within the organization whose task it is to ensure implementation of the plan. Accordingly, this needs to be a very disciplined person who is held in high respect by the employees. The champion needs to keep the pressure on the team to prevent people from reverting to their comfort zone of old methods. The champion should report directly to the CEO and should be the primary point person when important decisions need to be made. The champion should be a conduit for the flow of information among the various parties involved in the process.

9. MONITORING AND REPORTING SYSTEMS

9.1 Types of Reporting and Monitoring Systems

Reporting and monitoring systems must provide reliable information on a timely, consistent basis. For performance measurement, all who need it to do their jobs must be able to easily access the information. Without this feedback, the success of action plans cannot be evaluated and modified on a timely basis.

The most common reporting system may be computer spreadsheets or existing management software. Depending on the work group, however, the reporting system might be as simple as handwritten notes on whiteboards on the shop wall, or other signs posted in break rooms or elsewhere in the office. The information might also be communicated through e-mail, private Web pages, or company newsletters.

Information may also be obtained from performance measurement software applications. See section 5.6 for a discussion of the AICPA's *CPA Views* software.

9.2 System Security

As new information users access reports from the company's computer network, password protection is necessary to ensure the accessing rights to enter data, modify data, or read data are set based on each user's needs. Sensitive information should be security-controlled from a single point for the entire network. Some information may be accessible to the entire organization, while other data need high levels of security clearance. Unique login and password controls should be assigned to each user that accesses information within the network. User groups

might include system administrators, measure owners, owner assistants, data-entry users, commentary-entry users, or users with read-only access.

See the chapter "E-Business" for more information on information technology security systems.

9.3 Evaluation

As the performance measurement reporting system is implemented, the planning team will need to evaluate how well performance measures are actually modifying employee behavior and affecting the overall performance of the company. Planning teams should determine how often each measure is updated and reviewed and reassess the desired frequency of each.

The planning team should assess how well measurement-based decisions and action plans are communicated throughout the company. This may be seen in how the company allocates resources of working capital and labor, develops compensation plans, focuses on initiatives, and expands on existing action plans.

10. PERIODIC REALIGNMENT OF TARGETS

10.1 Structured Review Process

It is important to recognize that the planning team is not an ad hoc committee whose task is completed upon deployment of a performance measurement system. It should be a standing committee charged with ongoing evaluation. The planning team should, ideally, consist of individuals who understand the strategic direction of the company, are motivated for change, communicate effectively, and come from multiple disciplines within the company.

10.2 Periodic Evaluation

At least twice annually, the planning team should meet to discuss the success of implementing and sustaining the performance measurement process. More frequent meetings may be required where significant changes or rapid improvements have occurred.

The committee's ongoing purpose is to assess if the right things are being measured and whether the performance being measured is in alignment with the company's vision and mission statements. Basic

changes in the economy and marketplace may change the selected critical success factors. The committee should also evaluate if the targets or ranges are still reasonable or in need of redefinition. Appendix 6 contains a questionnaire to assist in evaluating and realigning targets and measures.

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APPENDIX 1: Client Readiness Questionnaire*

Have your client complete this questionnaire to assess its readiness to engage in a CPA Performance View initiative.

1. Are there organizational issues that keep you awake at night?
   ____Yes ____No
   What are some of these issues? ____________________
2. Does your organization need to become more competitive in the marketplace? ____Yes ____No
   In what ways are you not competitive? ____________________
3. Is your organization growing, and does it have a need for improved leadership and management effectiveness? ____Yes ____No
4. Does your organization have clearly stated goals and objectives? ____Yes ____No
5. Are people willing to change when new organizational strategies require it? ____Yes ____No
6. Do you have a regular process for planning on a periodic basis? ____Yes ____No
7. How often do you gauge yourselves against the plans you created? ____Daily ____Weekly ____Monthly
   ____Semi-Annually ____Annually ____Almost never
   ____Other, specify ____________________
8. Is there pressure on the organization to make more money?
   ____Yes ____No
9. Are shareholders unhappy with recent financial performance?
   ____Yes ____No
10. How serious is leadership about making changes?
    ____Very interested ____Interested
    ____Somewhat Interested ____Not interested
    ____Extremely interested
11. What type and level of leadership is leading this initiative?
    ____Type ____Level
12. Are there leaders within the organization that have participated in planning similar changes in the past? ____Yes ____No
13. Have previous efforts been made to adopt new procedures?
    ____Yes ____No
14. Where are the stress points in the organization? ____________________
15. Are there visible potential roadblocks for engaging in a change-oriented initiative? ____Yes ____No
    What are they? ____________________

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16. Will top leadership give visible, sustained support for the initiative? _____Yes _____No
17. Are there identifiable champions within the organization that will assist with implementation of CPA Performance View services? _____Yes _____No

APPENDIX 2: Checklist for Planning Documents and Existing or Prior Consulting Relationships*

This checklist is not meant to be exhaustive. Use this checklist as a guide to obtaining and reading the pertinent prior performance and planning initiatives the organization has undertaken. This can also be used in engagements in which no prior planning has been done, as a guide for what types of statements and information will be useful to generate throughout the process.

Planning Documents

Mission statement	Yes ☐	No ☐
Vision statement	Yes ☐	No ☐
Written strategic plans	Yes ☐	No ☐
Audited financial statements with footnotes	Yes ☐	No ☐
Divisional financial statements	Yes ☐	No ☐
Ratio analysis or other financial analysis	Yes ☐	No ☐
Budgets or financial forecasts	Yes ☐	No ☐
Benchmarking activities	Yes ☐	No ☐
Organizational goals and objectives	Yes ☐	No ☐
Organizational chart	Yes ☐	No ☐
Business plans	Yes ☐	No ☐
Sales plans	Yes ☐	No ☐
Customer services questionnaires and results	Yes ☐	No ☐
Customer satisfaction surveys	Yes ☐	No ☐
Business growth plans	Yes ☐	No ☐
Facility expansion plans	Yes ☐	No ☐
Employee relations plans	Yes ☐	No ☐
Employee training and development plans	Yes ☐	No ☐
Capital budgeting and investment plans	Yes ☐	No ☐
Process-improvement plans	Yes ☐	No ☐
ISO 9000 plans	Yes ☐	No ☐
SPC reports	Yes ☐	No ☐
Continuous quality improvement reports	Yes ☐	No ☐
Minutes from the board of directors and committees meetings	Yes ☐	No ☐
Other:	Yes ☐	No ☐

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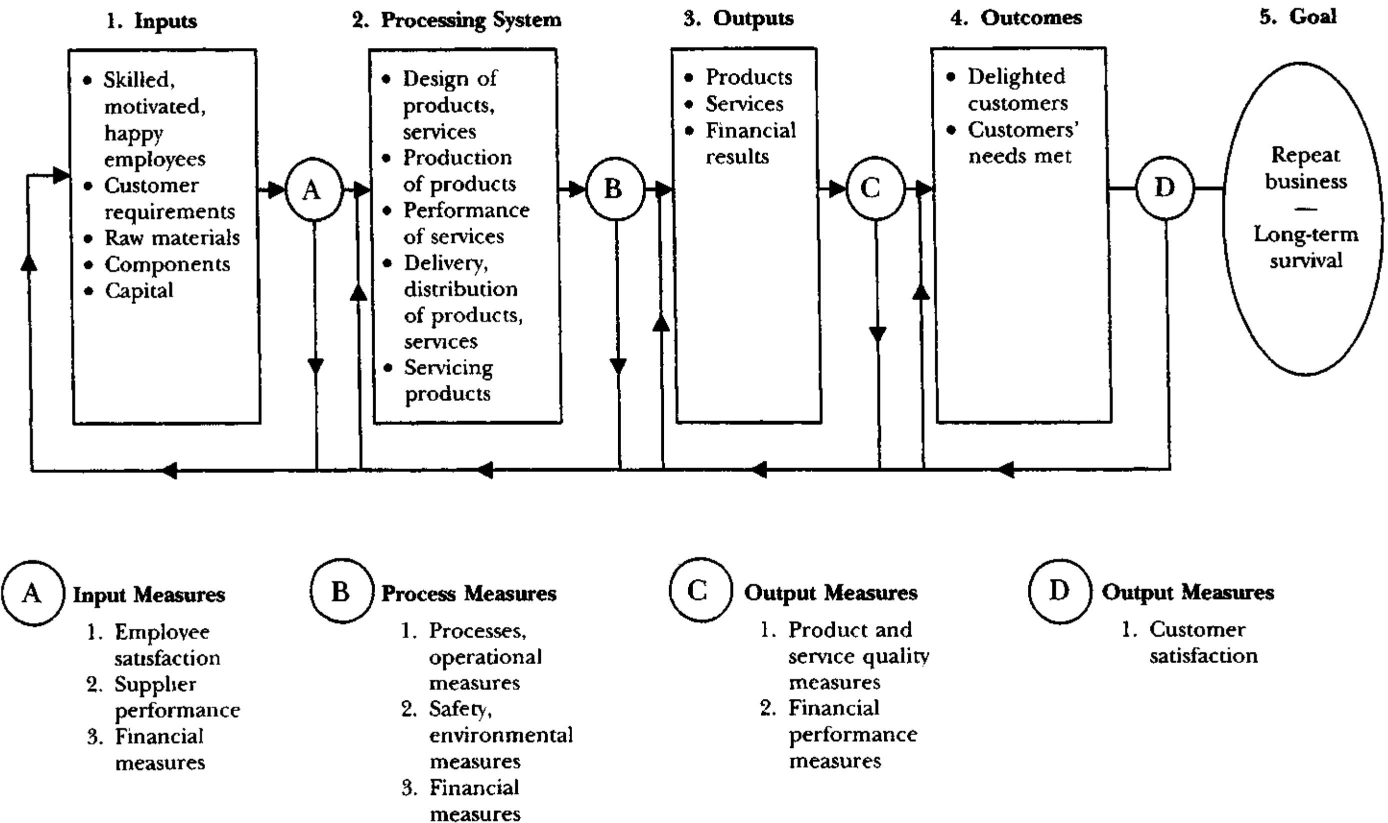
APPENDIX 3: Value Chain Illustration*



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APPENDIX 4: Key Performance Indicator Work Plan

Function/Goal	*Key Performance Indicators*	*By Whom*	*Frequency*	*To Whom*	*Purpose*	*Corrective Action/ Enforcement*
1. The revenue cycle						
a. Creating work-in-process (WIP)	• Charge hours		Monthly	Accountants	To ensure revenue projections are met	Performance review
	Compare actual hours charged to budget for each accountant (period and YTD)			Managing partner		Compensation
	• Utilization rate		Quarterly	Exceptions to managing partner	To measure staff productivity	Assess whether shortfall due to unproductive time
	Compare charge hours to available hours on summary basis (period and YTD over prior year)					Discuss with team
b. Turning WIP into AR	• WIP aging by primary and firm (current vs. prior year or target)		Monthly	Exceptions to managing partner	To measure timeliness of billing	Firm administrators meet with accountant
	• WIP over $400 and 90 days by primary accountant		Monthly	Managing partner	To ensure progress billing occurs	Supervisor discusses with accountant
						Supervisor bills for account

	• Realization % by accountant (YTD vs. target)	Monthly	Administrator	To evaluate billing rate and efficiency	Supervisor discusses
		Semiannually	Managing partner		Performance review
					Compensation
c. Collecting AR	• Average age of AR to prior year or target	Monthly	Administrator	To evaluate collection efforts	
	• AR over 90 days by client	Semiannually	Primary administrator	To identify problem clients and develop workout	Suspend future work
			Managing partner		
2. *Financial statement*	• Review prior year budget to year-end financials	Annually	Managing partner	To target profitability	Explore negative variances
	• Cash, WIP, AR, LOC, receipts	Weekly	Managing partner	Flash report	Step up billing meetings
	• Accrual basis financial statement	Monthly	Board	To monitor profitability	
	• Compare period and YTD total revenue, expenses, and NI to budget	Monthly	Board	To monitor profitability	

Function/Goal	*Key Performance Indicators*	*By Whom*	*Frequency*	*To Whom*	*Purpose*	*Corrective Action/ Enforcement*
3. *Client service*	• Client fees divided by number of clients to determine amount of service provided to each client		Annually	Managing partner	To measure cross-selling of services	Increase marketing of services to existing clients
	• Clients won/lost		Annually	Administrator	To measure growth	Use in conjunction with average client fees to determine staffing
	CPA Software report of files opened and closed			Managing partner		
	• Total revenue and average rate billed for new service areas		Annually	Administrator	Assess penetration of new client services	Marketing
				Managing partner		

Critical Success Factors					
1. *Timely service*	• % of tax returns completed within one month of interview by primary accountant	Annually	Administrator	To meet client expectations for timeliness	Meeting with accountants who have slowest turnaround
	• % of audits and reviews out within 75 days of year end	Annually	Managing partner	To meet client expectations for timeliness	Discuss exceptions with A&A manager
2. *Substantive advice*	• Random review of 5 TR memos per client for content	Annually	Feedback to each accountant	To provide added value	Additional training
3. *Skilled personnel*	• Review of CPE content and hours for each accountant	Annually	Administrator	To ensure staff has proper skill set	Performance evaluation and career counseling

APPENDIX 5: Financial Ratios

LIQUIDITY RATIOS

Ratio		*Formula*	*Interpretation*
Current Ratio	=	$\frac{\text{Current Assets}}{\text{Current Liabilities}}$	Indicates the extent to which current assets cover current liabilities. Attention should be paid to trends.
Quick Ratio	=	$\frac{\text{Cash + Cash Equivalents + Net Receivables}}{\text{Current Liabilities}}$	A conservative view of creditors' protection, since inventory and prepaid items may not always be liquid. A company is usually in good liquid position when quick assets exceed current liabilities.
Working Capital	=	Current Assets – Current Liabilities	Working capital is a direct indicator of the company's ability to grow.
Inventory to Working Capital	=	$\frac{\text{Inventory}}{\text{Working Capital}}$	Indicates the percentage of working capital supporting inventory. A high percentage indicates operating problems.
Current Assets Turnover	=	$\frac{\text{Cost of Goods Sold + Operating Expenses + Tax − Noncash Expenses}}{\text{Current Assets}}$	Indicates the number of times current assets must turn over to cover expenditures. Measures control of current assets.
Inventory to Current Liabilities	=	$\frac{\text{Inventory}}{\text{Current Liabilities}}$	Shows the degree to which the company relies on inventory to meet its current obligations.

PROFITABILITY RATIOS

Ratio		*Formula*	*Interpretation*
Gross Profit Percentage	=	Gross Profit / Net Revenues	Reflects control over cost of sales and pricing policies. The ratio must be viewed in relation to the client's past performance and the industry average
Operating Profit Percentages	=	Operating Profit / Net Revenues	Indicates the company's ability to control operating expenses The ratio should be viewed in relation to increased sales and changes in gross profit
Net Income Before Taxes Percentage (NIBT)	=	(Income Before Taxes + Extraordinary Items) / Net Revenues	Provides a more consistent basis for comparisons. It is also used in the calculation of other ratios.
Net Income After Taxes Percentage (NIAT)	=	Net Income After Taxes / Net Revenues	Reflects the tax effect on profitability and represents the profit per dollar of sales.
Return on Equity*	=	NIAT / Stockholders' Equity**	Measures the return to stockholders and represents their measure of profitability When compared to the return on assets, this ratio indicates degree of financial leverage
Return on Assets*	=	NIAT / Total Assets** or NIAT Percentage × Assets Turnover	Reflects the earning power and effective use of all the resources of the company

*Can be calculated by using operating income, NIBT, or earnings before interest and taxes (EBIT)

**When material transactions affecting the balance have occurred, an average balance should be used in the calculations

EFFICIENCY RATIOS

Ratio		Formula	Interpretation
Accounts Receivable Turnover	=	$\frac{\text{Credit Sales}}{\text{Average Accounts Receivable}}$	Indicates the number of times it takes receivables to turn into cash per year. Attention should be paid to credit terms, billing procedures, trends, and industry average.
Accounts Receivable Collection Period	=	$\frac{\text{360 or 365 Days}}{\text{Accounts Receivable Turnover}}$	Reflects average length of time from sale to cash collection.
Inventory Turnover	=	$\frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$	Indicates the number of times the business liquidates its inventory over a period and whether too little or too much inventory is carried.
Inventory—Days in Inventory	=	$\frac{\text{360 or 365 Days}}{\text{Inventory Turnover}}$	Reflects the number of days it takes to sell the inventory. Used in conjunction with accounts receivable collection period to determine operating cycle
Operating Cycle	=	Accounts Receivable Collection Period + Days in Inventory	Indicates the length of time it takes to convert inventory to cash. If the cycle increases, more permanent working capital is needed.
Accounts Payable Turnover	=	$\frac{\text{(Cost of Goods Sold − Beginning Inventory) + Ending Inventory}}{\text{Average Accounts Payable}}$	Indicates the number of turns per period of time it takes for the company to pay its trade payable. Should be compared to credit terms.
Accounts Payable—Days Outstanding	=	$\frac{\text{360 or 365 Days}}{\text{Accounts Payable Turnover}}$	Same as above but expressed in number of days rather than number of turns.
Assets Turnover	=	$\frac{\text{Net Revenue}}{\text{Total Assets*}}$	Indicates the turnover rate of total assets to achieve net revenue. When viewed historically, ratio indicates the effectiveness of generating sales from assets expansion.
Net Revenue to Working Capital Turnover	=	$\frac{\text{Net Revenue}}{\text{Working Capital}}$	An indication of the amount of working capital required to support sales. An increasing ratio may, for example, indicate insufficient working capital to support sales growth.
Net Fixed Assets to Stockholders' Equity	=	$\frac{\text{Net Fixed Assets}}{\text{Stockholders' Equity*}}$	Indicates the proportion of stockholders' equity that is committed to fixed assets and is not available for operating funds. A low percentage would indicate a favorable liquid position

EFFICIENCY RATIOS

Altman Z Score = The Altman Z Score, developed by Edward I. Altman, is a composite formula that is widely used to measure the financial "health" of a company The formula takes financial ratios and multiplies each by a specific constant. The amounts so computed are added together to obtain an overall score This score is then compared to scores from other companies to rate relative financial health These scores could be helpful in evaluating a "going concern" The formulae are as follows

For Corporations (five variables)

$$\frac{\text{Working Capital}}{\text{Total Assets}} \times 012$$

$$\frac{\text{Retained Earnings}}{\text{Total Assets}} \times 014$$

$$\frac{\text{Earnings Before Interest and Taxes}}{\text{Total Assets}} \times .033$$

$$\frac{\text{Market Value Equity}}{\text{Book Value of Total Liabilities}} \times 006$$

$$\frac{\text{Sales}}{\text{Total Assets}} \times 999$$

For Private Companies (five variables)

$$\frac{\text{Working Capital}}{\text{Total Assets}} \times 717$$

$$\frac{\text{Retained Earnings}}{\text{Total Assets}} \times 847$$

$$\frac{\text{Earnings Before Interest and Taxes}}{\text{Total Assets}} \times 3\ 107$$

(continued)

*When material transactions affecting the balance have occurred, an average balance should be used in the calculations

EFFICIENCY RATIOS (*continued*)

Ratio	*Formula*		*Interpretation*
	$\frac{\text{Net Worth (Book Value)}}{\text{Total Liabilities}}$	× .420	
	$\frac{\text{Sales}}{\text{Total Assets}}$	× .998	
For Private Companies: (four variables)	$\frac{\text{Working Capital}}{\text{Total Assets}}$	× 6.56	
	$\frac{\text{Retained Earnings}}{\text{Total Assets}}$	× 3.26	
	$\frac{\text{Income Before Interest and Taxes}}{\text{Total Assets}}$	× 6.72	
	$\frac{\text{Net Worth}}{\text{Total Liabilities}}$	× 1.05	

Score	*Probability of Failure*
1.8 or less	Very high
1.81 to 2.7	High
2.8 to 2.9	Possible
3.0 or higher	Very low

CAPITAL STRUCTURE RATIOS

Ratio		Formula	Interpretation
debt to equity	=	$\frac{\text{total debt}}{\text{stockholders' equity*}}$	Indicates the relation of the owners' and creditors' positions. This ratio should be viewed in the light of industry averages.
current debt to equity	=	$\frac{\text{current liabilities}}{\text{equity}}$	Indicates the proportion of debt to total equity that is current in maturity. A high ratio may indicate the need to restructure debt
operating fund to current portion of long-term debt	=	$\frac{\text{NIAT + noncash expenses}}{\text{current portion of long-term debt}}$	Shows the ability of the company to meet its current payments.
times interest earned	=	$\frac{\text{NIBT + interest}}{\text{interest}}$	Shows how well the company is able to cover interest from earnings. Measures the level of earnings decline to meet interest payments.
long-term debt to equity	=	$\frac{\text{long-term debt}}{\text{stockholders' equity*}}$	Measures the relationship of long-term debt to equity

*When material transactions affecting the balance have occurred, an average balance should be used in the calculations

APPENDIX 6: Realignment Questionnaire*

Before meeting with the client's performance measurement teams, the following questions and other possible questions should be reviewed to make the realignment process as effective as possible.

Questions

Question		
Have the strategic objectives and goals of the organization changed?	Yes ☐	No ☐
Are the mission and vision of the organization still relevant?	Yes ☐	No ☐
Are there new market factors that need to be taken into account when realigning measures, critical success factors or targets?	Yes ☐	No ☐
Do we experience new competition in our marketplace that needs to be addressed?	Yes ☐	No ☐
Do we have additional information or data available that was unavailable before?	Yes ☐	No ☐
How long has the performance measurement system been in place?	Yes ☐	No ☐
Has it been in place long enough to evaluate its effectiveness?	Yes ☐	No ☐
Are we measuring the right things?	Yes ☐	No ☐
Does the performance being measured line up with the organization's vision and mission?	Yes ☐	No ☐
Are the selected critical success factors still critical?	Yes ☐	No ☐
Are the targets or ranges reasonable?	Yes ☐	No ☐
Are the targets too easy and not stretch targets?	Yes ☐	No ☐
Do the targets need to be redefined?	Yes ☐	No ☐
Should anything else be changed?	Yes ☐	No ☐

*See *CPA Performance View Services: A Practitioner's Guide to Providing Performance Measurement Engagements,* by Stephen H. Coleman and Thomas G. Wagner (New York: AICPA, 2000). All rights reserved.

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Business and Succession Planning (Volume 2)	BP
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Federal Corporate Tax Notes (Volume 2)	CORPTAX
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Employment Regulations	EMP
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