

taxolutionsSM

Are Your Agreements Doing What They're Supposed To?

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Agreements can be a tax minefield. They may not have been set up to meet your tax goals and there may be one, or more, tax bombs ready to explode.

Problems can arise in a variety of ways. Maybe you worried so much about getting “the deal” down on paper that you didn’t focus on the tax consequences. Even if existing agreements properly reflect the tax treatment you desired, recent tax law changes or changes in your business or family status may render that treatment incorrect or unwanted now. For example, does your buy/sell agreement indicate that the value of the business will be an agreed upon value? If so, has this value been updated recently?

Identify Documents With Tax Impact

The first step is to identify documents for an Agreement Review. The following types of agreements are typical: shareholder (or partner/member), buy/sell, employment, non-qualified deferred compensation, consulting, and leasing. Look at everything. Agreements may be interrelated, or some adverse tax effect might be lurking in the employment agreement instead of the shareholder agreement.

When looking at employment agreements, don’t forget about non-owner key employees. Their agreements may also impact the company’s tax situation.

Determine Your Tax Objectives

Reflect on your tax goals as they relate to each document and the action it calls for; and also consider your overall tax objectives with regard to your business and financial planning. This may include major goals, such as transitioning your business and having enough cash to retire comfortably, as well as minor goals, such as rewarding a key employee or getting cash distributions sufficient to make quarterly estimated tax payments.

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Don't Be Caught Unaware... State Taxes Deserve Attention

For years, state taxes have commanded little respect. They were just that annoying add-on at tax time that increased your overall tax bill. Now, more and more states are giving us a wake-up call. States are becoming aggressive, and sometimes downright contentious, in their pursuit of the almighty tax dollar. A good example is the recent fraud indictment against a Tyco executive charged with cheating New York out of more than a million dollars of sales tax.

In their desperation to gain tax funds, states have become more systematic in their efforts to collect their “fair share.” And, with more companies doing business in multiple states and more individuals owning investments in other states — a collision with the state tax collector may be inevitable.

State vs. Federal

In the past, most state tax rules followed federal. Now, more states are picking and choosing which federal rules to follow. State differences can cause tax effects you weren't anticipating. These variances are found in areas such as S corporation status, depreciation deductions, net operating losses, and other deductions. The recent 30% bonus depreciation change is a prime example. Congress added this break in March 2002, but some states are resisting the new law.

Another example would be the estate “pick-up” tax. Many state inheritance taxes were based on the maximum federal credit allowed for state death taxes. With the 2001 change to the federal credit, states recognized that they would begin to lose money. Some states are rewriting their laws to recapture that money — possibly resulting in an overall death tax *increase* for taxpayers.

Got Nexus?

When do states get to tax you or your business? Usually they rely on “nexus.” What is nexus? Nexus means you have some element of business or investment present in that state. The states' definition of nexus is



getting broader... and more people are paying tax in more states. For example, if your business has a salesperson who spends only 2 days in Michigan on sales calls, your company may owe Michigan tax.

Not only does the definition of nexus differ from state to state, but one state may define nexus differently for different types of taxes. You might have nexus for sales tax purposes, but not for income tax. We can assess your situation to see if you have nexus in particular states, and how to avoid it or how to rearrange your activities in the state to minimize taxes.

States Are Not Created Equal

States have different tax rules and rates. Some states have no income tax, but high sales tax or property tax, or they may tax your investment assets. Use these differences to your advantage. If you are about to sell your business and plan to retire to a different state, it may be wise to make the move before the sale — particularly if you're apt to relocate to a state with no income tax.

Incentivize Me

Even at a time when many states are aggressively assessing and collecting taxes, some

states have “give-away programs.” They offer incentives for business expansion and business start-ups or relocation. Programs vary widely by state, but can include tax credits for business expansion, reimbursement for employee training programs, or credits for relocating to the state. These incentives may lure you over the state line, or help you choose the state in which to locate your new office or distribution center.

While you may have no plans to move or do business in another state, it's in your best interest to make sure you are taking advantage of all available incentives in your current business location.

What Can You Do?

Recognize that state taxes are a force to be reckoned with. Then, go on the offensive and plan to do battle. Call us to discuss the facts of your situation. We can help you minimize state taxes and take advantage of state quirks whenever possible. In many cases this means thinking about the effect of state taxes when contemplating a transaction and before making a final business decision.

It's Just What the Doctor Ordered

With healthcare costs skyrocketing, everyone's looking for ways to save money. The IRS recently established rules for a new type of medical reimbursement account that just might help — Health Reimbursement Arrangements, or HRAs.

What Is An HRA?

HRAs are employer-funded accounts that reimburse employee medical expenses, and carry forward any unused funds. Untaxed at the employee level, reimbursements are tax-deductible by the employer when paid to the employee. The “use-it-or-lose-it” rule and other burdensome rules that apply to Health FSAs within a Section 125 cafeteria plan do not apply to HRAs.

An HRA account reimburses the same type of expenses as an FSA. Defined as “medically necessary,” these include co-pays, deductibles, office visits, vision care, prescriptions, and most dental expenses. Expenses related to cosmetic services, such as teeth bleaching or facelifts, would not be eligible for reimbursement.

Employees may request reimbursement for medical expenses at the time services are rendered, accumulate them for reimbursement in the future, or save the funds in the HRA for retiree health benefits. Services for eligible expenses must be provided while the employee is covered by the HRA, but the request for reimbursement need not occur until months or even years later. Because funds accumulate from year to year, the employee decides when and how to best spend their medical benefit dollars.

How Does It Work?

An employer establishes an HRA by adopting a formal plan. As eligible expenses are submitted, the employee's personal account is reduced and paid to the employee on a non-taxable basis. At the end of the HRA coverage period, a new period begins with additional employer funding available. The employee keeps any dollars left over from the previous period.

Here's how an employee can benefit from an HRA plan:

Bill's employer began an HRA program to complement a new high-deductible health plan. The health plan for family coverage has a deductible of \$2,400. The HRA provides \$800 each year for everyone selecting this coverage.

Bill has a wife and two small children, and needs help with his current medical expenses. Bill knows he will spend \$100 per month just for prescriptions and doctor visits for the family. He elects to add \$1,200 to his FSA account and use the HRA for unexpected expenses. Bill has effectively eliminated his risk of loss in his FSA plan since his known expenses are at least \$1,200. And, if his family experiences unexpected medical expenses during the year, the HRA is there to pay for qualified medical expenses above the \$1,200 FSA election.

Tailor HRAs To Objectives

The rising cost of healthcare is a concern for most employers. By adding an HRA, employers can enhance their benefit package while achieving their overall goals of lowering health benefit costs or capping costs at their current levels. Here are three approaches:

1. Implement a high-deductible health insurance plan.

By implementing a high-deductible health plan, premiums decrease and an employer will save money. However, employee satisfaction may erode, causing turnover and higher recruiting and training costs. An HRA could turn the tide in the employer's favor.

By making part of the deductible increase available to employees each year through an HRA, employees have more control over medical expenses and less risk of paying deductibles with after-tax cash. The employer will have less insurance expense and only be liable for a small

portion of each employee's HRA account each month.

A portion of the HRA limit is added to each account once per month or pay period, and only those funds are available for reimbursement.

2. Eliminate the “use-it-or-lose-it” rule associated with the Health FSA.

Employees are skeptical about having more dollars deducted from their paycheck — even if they save taxes. Add in the risk of loss on unused amounts, and a lot of employees won't sign up for the employer's FSA. With the employer “guarantee” in the form of an HRA, employees feel better about their FSA so you get better participation. Better participation means tax savings for both employer and employees. The employer saves on overall healthcare costs and payroll taxes while the employee saves on both social security tax and income tax.

3. Fund retiree benefits.

If you want to retain good employees and offer them a benefit at retirement, you could design an HRA program that covers retiree benefits. Employees may use their HRA for current expenses or build up their account for expenses after retirement, such as long-term care insurance. Benefit costs for current employees are capped and there is no need for additional funds for employees at retirement time.

HRAs Enhance FSAs

One plan design usually doesn't fit everyone's needs. That's why Section 125 Cafeteria Plans have become such a popular benefits tool. With the addition of an HRA, employers have more choice in deciding how much to spend on benefits and how the benefits are delivered to their employees. Employees have a greater say in how their benefit dollars are spent. An HRA is a great way to meet these needs and boost the employer's benefit package. Call us for more information.

Are Your Agreements Doing What They're Supposed To?



Talk With Tax Adviser

It's critical to discuss what your tax objectives are as they relate to business agreements. Don't forget this may also impact your retirement planning, estate planning, or planning for your children's education. Let us review your agreements to see if they are consistent with your tax goals. This review may also point out other areas which need planning to minimize adverse tax effects. For example, a stock option plan may not need revision of the document, but may indicate the need for AMT tax planning in order to avoid a true tax bomb.

What To Look For

It's impossible to anticipate everything, but, here are some things to look for. And remember, what's *not* in a document may be just as important as what is.

- Is life insurance set up correctly?
- Is capital gain treatment maximized?
- Is there a plan for determining asset values upon sale or transfer?
- If buy/sell is computed by formula, does the formula meet tax requirements and is it updated as frequently as needed? Should it be changed to minimize update needs?
- Is compensation maximized?
- Are other payments to owners maximized?
- Do you, or other owners, have goodwill or other assets/intangibles which are held at the individual level (and which should be documented)?
- S corporations
 - Should there be provisions for the cut-off election?

- Should there be limitations on transfer to ineligible shareholders?
- Are distributions adequate to cover estimated tax?
- Partnerships
 - Is indebtedness allocation consistent with allocations of distributions and tax attributes? Are there any basis or at-risk problems for partners?
 - Do distribution provisions for dissolution comply with tax requirements and still properly reflect the business deal between the partners?
 - Should the buy/sell call for capital account adjustments to meet IRS requirements?

If you haven't had your agreements reviewed lately, now is the time to get it done. And make it a habit. Defuse those tax bombs by addressing the tax treatment and by monitoring for needed changes over the years. As always, we're here to help. Call us.

news and notes

In July, the IRS issued new rules on the tax treatment of split-dollar life insurance policies. These rules apply for purposes of federal income, employment, and gift taxes. The broad scope of these rules can affect the tax treatment for the employer, owner-employees, other employees, donors, and donees. Substantially different tax consequences result depending on which party owns the life insurance contract and whether the premium payment is considered compensatory or a loan.

These new rules were issued as proposed regulations and are effective for split-dollar arrangements entered into after publication as final regulations. Existing arrangements can avoid IRS recharacterization by meeting the safe harbor requirements set forth in the proposed regulations and a related IRS notice.

Supreme Court Okays IRS Tip Estimates

In what has been described by the National Restaurant Association as "a heavy blow against the restaurant industry and many other small businesses," the Supreme Court approved the IRS' use of the "aggregate estimation method" to calculate a restaurant's employment tax liability for unreported tip income. For more information on how this could affect your business, please give us a call.

Replace Current Tax System?

Panelists at a recent symposium sponsored by the *Institute for Policy Innovation's Road Map to Tax Reform* declared the current tax system confusing and unfair. Speakers called for a system that is simple, transparent, and neutral. Once again, candidates for replace-

ment tax systems included a national sales tax, consumption tax, flat tax, and a cash-flow tax. What are these? Well, there may be several variations — each with their own definitions. Primarily consumption-based, these tax systems would seek to give more control to taxpayers by taxing spending rather than earned income.

A simpler, fairer tax system would appeal to all. A popular Beatles lyric goes, "You say you got a real solution, well you know we'd all love to see the plan." But, will we see it anytime soon? Probably not. Replacing or overhauling our current tax system is a massive undertaking. And transitioning to a new system would generate tremendous problems for people who have relied on the existing law in their transactions and tax planning.