The Business Owner®

An Information Service for You, Family, and Business

Resolution for 2002: Review These Big-Ticket Ideas

It's easy to miss the details when you're focused on the "big picture" of your business, your family, and your assets. Here are dozens of suggestions to help you save current dollars, protect your assets, reduce and defer taxes, increase cash flow, and minimize your personal and business risk today and in future years. Note the applicable ideas and discuss implementing them with your advisers.

q **Insurance strategies.** Look into split-dollar insurance to lower net premium cost and build more cash value in life insurance policies • Consider an insurance trust to hold life insurance policies for spouse and children to provide income and lower family taxes • Update insurance beneficiaries and provide for contingent and tertiary beneficiaries • Review disability insurance and consider a wage-continuation plan • Check settlement options in life insurance policies, particularly for younger children • Arrange for dividends to buy more life insurance coverage • Report all PS 58 income on your personal tax return to avoid taxation of life insurance proceeds • To avoid unintentional lapses in your life insurance policies, be sure all of your personal and business policies provide for *automatic* payment of premiums from the policies' cash values.

q **Retirement strategies.** For tax-free growth of income and capital gains, continue to make IRA contributions (even if they're not deductible) and voluntary 401(k) contributions above the annual limits • To increase current deductions and future retirement income, set up a Keogh plan for any second source of income • For older business owners: Establish a defined benefit plan so you can exceed the usual $40,000 annual maximum on money set aside for retirement • Review all your options on receiving retirement money and get advice from several professionals before choosing one; the tax consequences can be severe • Consider a deferred compensation plan to lower current personal taxes and build more retirement savings • Look into a Simplified Employee Pension Plan (SEP): No IRS approval needed, less administrative work, contribution up to 25% of salary ($40,000 maximum a year) • If your company is tight on cash, consider a SIMPLE Plan in which employees fund the plan with their own money through pre-tax salary reductions of up to $7,000 annually; employers then match employee contributions dollar-for-dollar up to 3% of each employee's annual compensation.

q **Ownership.** Effect a buy-sell agreement with other owners • Be sure the buy-out price is up-to-date if you already have a buy-sell • If you plan to or have issued, gifted, transferred, or sold stock, warrants, or convertible securities, be sure that (a) an investment agreement was prepared and signed, (b) the stock has a legend on it referring to the underlying investment agreement, and (c) you restrict its transfer, encumbrance, or sale • Have the right of first refusal for both you and the company to repurchase any shares • Get indemnification from the buyer of any stock • Bind all future recipients of the shares to the terms of the investment agreement • Use a lawyer who is experienced in the sale and issuance of securities.

(Continued on the next page)

THE REFERENCE SOURCE for owners and managers and the professionals who advise them

An Information Service to Increase and Protect Your Wealth

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Checklist of Strategies With Big-Dollar Pay-Offs

q **Your spouse and children.** Set up a 529 Tuition Plan, Education IRA, and/or custodial accounts to provide for children's education • Make gifts, particularly of highly appreciated securities, to your children so the gains can be taxed at *their* lower rates • Update your will to include a bypass provision (not included in many older wills) and a living or revocable trust • Give your spouse a blank-check option in your will so he or she has the right to change the amount and form in which the assets are received • Look into second-to-die life insurance to lower premiums and provide for estate taxes and financial support for your children.

q **Employees and executives.** Prepare formal employment contracts or memos of understanding to provide for the following: (a) terms of employment, (b) protection against misuse of privileged and confidential company information, (c) prevention of departed employees or executives from using their knowledge to compete against the company, and (d) automatic termination of employment for any of the following: a material breach of an employment contract, fraud or embezzlement, and disclosure of the company's trade secrets, marketing plans, etc., to persons outside the company.

q **Home office deductions.** *Basic rule:* You can claim a home office deduction if your home office is used to conduct essential day-to-day administrative or management activities and you don't have a suitable alternative. If you qualify to deduct home office expenses, you must list your deductions on IRS Form 8829, *Expenses for Business Use of Your Home,* and attach it to Form 1040 when you file your tax return. Form 8829 is also the place where you determine the percentage of your home allocated to business use, computed as follows: 1,000 square feet of business use divided by 5,000 total square footage equals 20%. That 20% is then used to calculate the share of depreciation, utilities, home insurance, etc., attributed to the home office. *Reminder:* Keep a *time log* on the time you spend in your home office, on the road, or at another location to document the business use of your home office and travel.

q **Personal loans to and from your business.** If you're the borrower, formally execute a promissory note and provide for an interest rate and repayment schedule • Try to secure the loan • Have the company's Board of Directors approve the loan and its terms • If you're the lender and major stockholder, check with your accountant on the thin capitalization rules (i.e., high debt-to-equity ratio) • Be careful of the IRS reclassifying your loan repayments as additional salary or dividends • *Bottom line:* As an owner/borrower/lender, be sure all of the terms of the promissory note are met.

q **Corporate matters.** Take detailed, complete meeting minutes and keep them current • Provide in corporate minutes for personal indemnification by your business for any future expenses that might be incurred in defending a stockholder suit • Be sure bylaws permit your removal of any officer at any time for any reason • Get employment contracts and noncompete agreements from key people • Avoid accumulated earnings tax of 38.6% by documenting your capital requirements and need to retain cash in the business • Consider electing or switching to S corporate status or to a limited liability corporation; analyze differences in personal and business tax rates to make the decision. *(Continued on the next page)*

Checklist of Strategies — *Continued from page 2*

q **Recordkeeping.** Keep *indefinitely* all records that establish your cost basis for tax purposes (e.g., home, investments, antiques, etc.) • Set up separate files for capital improvements to your home, retirement contributions and annual statements, income receipts, tax-deductible expenses, and Social Security benefits • Keep all cancelled checks for charitable donations and written documentation from charities for gifts of $250 or more • Keep copies of your signed will at home and with both your lawyer and accountant • Prepare a memo for your heirs on the location of important papers: Your will(s), insurance policies, deeds, personal financial statement, tax returns, cost basis of assets, business papers, succession or buy-sell agreement, etc.

q **Overall planning.** Calculate today how much retirement income you will need (most experts say 50% to 80% of your current salary) • Prepare a Worksheet projecting your income and expenses for post-retirement years; use different returns on your accumulated retirement funds (e.g., 6% and 10% annually) • Know your tax brackets — personal, children, and business — so you can move income between you and your business, among family members, and from year to year to reduce taxes • Personally own select business assets, e.g., real estate and equipment, to build equity outside your business.

How to Stay Out of Trouble

Recognize conflicts of interest: You are owner, employee, and board member • Deal with your business and family on an arm's-length basis • Document transactions in corporate minutes • Deal with minority owners on a fair and equitable basis and get their approval on major transactions which involve you, your business, and/or your family • Execute formal agreements on salary, rentals, loans, sales and purchases • Be careful of prohibited (self-dealing) transactions with your pension plan • Be sure your retirement plan has been updated to reflect current tax laws and tax-saving options • On company/family business, try to use two lawyers; don't have your company's lawyers represent your family members.

Targeted Business Areas For IRS Auditors

Businesses that transact in cash • Forms 1099, W-4, and W-2 compliance • Timely payment of payroll, sales, and income taxes • Personal use of business property, particularly autos • All cash and property transactions between the company and its owners, including related parties of the owners and affiliated businesses • Compensation and benefits paid and expenses reimbursed to owners and related parties • Cost basis, loans, and loan repayments from owners in partnerships and S corporations • Loans and advances to owners, officers, board members, and related parties • Form K-1 filings by owners of S corporations, partnerships, and limited liability companies • Intermingling of business receipts and deposits with personal accounts • Auto use, diary, and mileage log • Business entertainment and travel, seminars, conventions, and deductions for spouses who accompany owners on business trips • Improper classification of employees as independent contractors • Inter-company transactions with affiliated businesses owned by the company or its stockholders • Valid, current, and complete corporate minutes • Life and health insurance premiums claimed as deductions • Retirement plan filings, contributions, and overall compliance with deadlines and regulations.

Personal Audit Areas

Unreported income for which the IRS received a Form 1099 or other income notice • Rental of vacation or second home • Charitable donations of property • Alimony, dependent exemptions, support payments • Retirement contributions and rollovers • Home office and related business expenses • Investment losses, expenses, reinvestment records, and uncollectible loans • Interest on mortgage loans and real estate taxes • Estate, gift, and trust tax filings • Passive losses from real estate and other investments • Casualty losses, medical and dental expenses if they exceed 7.5% of your adjusted gross income • Gifts and inheritances • High miscellaneous itemized deductions • Hobby losses • Gambling winnings that offset losses.

Reference: For ways to avoid problems with the IRS, please see *Steering Clear of the IRS:* Special Alerts for Business Owners, page 20.

* * *

Financial and tax planning cannot be done in isolation; it's just too complex in today's environment. Call a group meeting with your advisers (accountant, tax consultant, estate planner, insurance agent, lawyer). Use the ideas in this advisory to prepare a meeting outline to assure that all your tax- and financial-planning strategies are in order and make good economic, business, and tax sense.

Copyright exception. Because of the importance of this article and the one on page 20, please feel free to copy and distribute them to your accountant and other advisers. q

Ideas to Increase and Protect Your Wealth

Two Owners Pay Premium Price to Silence Minority Stockholder

A company's bylaws were approved and filed with the state six years ago when the business was started by two stockholders, who each owned 50% of the company. The bylaws provided that a 100% vote was needed to approve major actions and changes. That was no problem as long as the company had only two stockholders.

But another individual joined the company a few years later, purchasing 20% of the business for $150,000. Of course, everyone had forgotten about the bylaw requirement for 100% stockholder approval to pass amendments, change the number of directors, and effect major transactions, such as sale of the business. The board, consisting of the three stockholders, also was required to get unanimous approval to declare dividends, pay bonuses, and increase officer/stockholder salaries.

Problem: The 20% stockholder contended he was not being treated fairly and that his $150,000 buy-in price now seemed way too high. He got tough and started to vote "no" on many transactions, particularly bonuses and salaries. The other two stockholders tried to elect another board member but were precluded from doing so because the bylaws specified: *The company's board of directors shall be its stockholders.*

Result: The 20% stockholder had to be bought out. It cost the company and the other two stockholders $350,000, more than double this minority stockholder's investment of $150,000 three years earlier.

Lesson: Review your bylaws and articles of incorporation on a regular basis every year or two. Review them automatically any time you're considering buying out or adding a stockholder.

7 Ways to Assure Payment on Contracts

1. Start by using written contracts to avoid misunderstandings. Oral contracts tend to change when the "going gets tough."

2. If available, consider using your industry's or trade association's standard contract form. It may help avoid disputes.

3. Provide in the contract for an interest rate on any monies not paid as contractually promised.

4. If the amount of the contract is substantial, consider depositing funds with an escrow agent or a law firm.

5. On questionable or delinquent customers, require a downpayment or use an installment payout, promissory note, or letter of credit.

6. Build an arbitration clause into contracts; it can save time and legal costs if there are disputes later on. But recognize that many arbitrations result in a compromise so, even if you're 100% correct on your position, you may have to settle for only 50% of your claim for damages.

7. Keep in mind that prior contracts with customers and your industry's customary practices will have legal weight in resolving any contract dispute; many times, they're the deciding factor.

Does Your Business Provide You with Personal Indemnification Insurance?

Question. Another business owner I know recently was threatened with legal action by one of his minority stockholders for excessive compensation and for the personal use of a company car. I own 80% of my company; three people own the other 20%. How can I protect myself against such a lawsuit?

Answer. Whenever there are minority owners, you have potential problems. As the principal owner and decision maker in your company, conflicts of interest can arise on whose interests you are best serving — yours or the corporation's. As a board member, you are supposed to watch out for the interests of *all* owners, not just your own.

The best ways to avoid conflict of interest charges are to refrain from voting on a company matter that *personally affects you* and to deal with your business on an arm's-length basis, i.e., as if you were dealing with an independent, unrelated person.

How to protect yourself: Provide for an indemnification clause in your company's bylaws and consider buying indemnification insurance. You may never need it but if the day ever comes when you are in litigation with a minority owner, lender, supplier, or other party, you will be glad that you have the protection.

More Ideas to Use Today

q What does "passive" activity mean? Generally stated, it is any trade or business in which the taxpayer does not "materially participate" in the company's operations; that is, the individual is not involved on a regular, continuous, and substantial basis.

Problem: As a general rule, if you are a passive investor, business losses are tax deductible *only* against income from other passive activities, such as rental income. This rule generally applies to individuals and owners in sole proprietorships, S corporations, partnerships, and limited liability companies.

What to do: If you fit in any of the above categories, meet with your advisers on the tax implications of passive income and losses. *Editor's note:* Any unused passive losses can be carried forward against future passive income or deducted when the property is sold.

q Liability alert: Employee use of company autos. Some business owners consider the loan of a company-owned car to employees for use *after* hours to be an easy fringe benefit. The problem is that personal use of a company-owned auto is not automatically covered in most property and casualty insurance policies.

For example, if an employee driving a company vehicle during non-working hours is involved in an accident, the business owner can expect a substantial premium increase. There also are associated costs for repairs and a replacement vehicle. If the accident is serious and involved another vehicle and/or people, there may be expensive litigation, not only for the driver, but also for the company as the owner of the auto. The accident victim isn't likely to be satisfied with suing only the driver of the vehicle.

What to do: If personal use of a company car is a benefit your company provides, talk to your insurance agent. There is insurance available to cover this additional liability.

q Contingent deals can cause trouble. If you're planning to sell a business or any asset, be very careful of deals structured on future profits. Try to get the value of your business *today;* any excess growth above a certain level can then be paid to you on a contingent basis, i.e., you receive *extra* money when your company's earnings exceed an agreed-on performance level.

Contingent payment terms can cause many problems, including questions from the IRS on the total selling price, which may increase your tax liability. Contingent deals also are an invitation to costly legal disputes, i.e., one party will claim the contingency was met, the other party will argue it was not. *Bottom line:* Stay away from contingent deals unless the up-front cash you receive is at least 75% of the total value of the deal.

q Owner restricted from future retirement plans. *The situation:* John Smith owned 100% of a Wall Street firm which had two seats on the New York Stock Exchange. He needed some temporary operating cash in his company so he looked at his 401(k).

Problem: Retirement plan borrowings from a 401(k) are limited to $50,000 but Smith borrowed $100,000, of which $75,000 was lent to his company.

Result: His company was audited and the prohibited transaction identified. Smith had to immediately repay the *full* $100,000; he also had to sign an agreement not to participate further in the retirement plan nor set up any other retirement plan for the next five years. In addition, he was assessed a 10% penalty on the excess $50,000 he borrowed.

q Business relationships do break up, no matter how well they start out. You're wise to build protection into all your agreements — *no exceptions.*

Written contracts protect businesses because they serve as a means of settling disputes, avoiding misunderstandings, and peacefully ending relationships.

• Before firing an executive, particularly one who is a shareholder, consult with your lawyer on any agreements with that shareholder/executive, e.g., buy-sell and employment contracts.

• Require noncompete agreements in all instances but particularly when a shareholder is also an employee of the company or when an officer is your key salesperson.

• Keep in mind that in contract law, many courts will rule against the company, favoring the rights of individuals.

q Protect your net worth. Ask your insurance agent about umbrella insurance. It's inexpensive insurance (around $300 annually for $1 million of coverage) that covers claims against you that exceed the limits of your usual coverage (e.g., home and auto insurance).

Example: If you seriously injure a person (say, a car accident) and are sued for $1 million, umbrella insurance will help protect your assets. If you already have this insurance, ask your agent to re-evaluate your needs based on your current asset position, which may have increased substantially since you originally took out the insurance.

q Get right to sublet for personal and business leases. Subletting is a major issue between tenant and landlord. Often, landlords object to subletting because they lose control in the selection of any new tenant. The fact is, however, if the office-space market is soft, as it is in some parts of the country, the landlord may not object. In any case, always negotiate for a subletting right; it gives you flexibility, especially in the event that you want to move or expand during the term of the lease.

q Personal liability on payroll taxes. In a court action, the IRS claimed all three partners of a company were personally liable for withholding and paying employee taxes which had not been paid. Of the three partners, only two had payroll authority. The third partner protested his liability, stating he had nothing to do with payroll matters. The court freed this partner from all liability and ruled that the IRS had to pay his legal fees because their action against this partner was unreasonable from the start.

Editor's note: This advisory is for information purposes only. As a general rule, personal liability in many tax and business matters can extend to all owners who are active in managing a closely held business.

q Protect your accounts receivable. Try not to leave 90-day overdue receivables on open account. Formalize the debt by having the customer/debtor sign a promissory note evidencing the indebtedness. If necessary, give your late-paying customer some time to repay. Consider six months to a year to pay off the debt, on a monthly basis. Of course, also try to get interest and collateral.

Another idea: Consider having the customer pay in advance for all new orders and add to that advance payment 25% of the past-due amount. That way, you still maintain the relationship and, by the time four new orders are completed, you will have collected the money owed you.

q Don't forget these often-overlooked personal deductions.

• An uncollectible loan personally made to another individual, deductible as a capital loss. Annual limit of net capital losses is $3,000.

• Penalties for early withdrawal of deposits from a time savings account are tax deductible.

• Points paid on a residential mortgage are tax deductible in the year paid. Points paid to *refinance* a home, or finance a business or investment mortgage, are tax deductible over the life of the mortgage.

• Casualty losses to the extent they exceed 10% of your adjusted gross income plus $100 per loss are tax deductible.

q Paying bonuses can cost less than salary increases. *Reason:* Many fringe benefits are provided under formulas relating to base pay — vacation pay and group life insurance, for example. By giving a bonus instead of a salary increase, the company can avoid increasing an employee's base pay and certain fringe benefit costs based on it.

Another benefit: Bonuses can be given selectively (and perhaps quietly) to a few employees to reward them for special performance without raising the general compensation level of everyone in that job classification.

q The rules on car phones. In order to qualify the expenses as a business tax deduction, the IRS requires a log of phone usage indicating the business purpose of the calls. *One way:* Simply indicate on your monthly telephone bill next to each call the individual you spoke to and the purpose of the call, then file the bill with your tax data.

Use of IRA as Collateral

Question. Can I use the money in my IRA to secure a personal loan?

Answer. If you do, the IRS will treat the IRA amount you used as collateral as a premature withdrawal. As a premature withdrawal, the full amount will be subject to income tax and, if you are *not* age 59½ or over, there will be a 10% early withdrawal penalty.

The best advice is to find an alternative source of money or use other collateral to secure the loan. Have you considered a home-equity loan? q

How to Structure Loans to Maximize Profits and Capital Availability

The need to raise capital to finance increased sales faces almost all business owners at some point in their company's growth. The methods and motivation for doing so are many:

- incurring bank debt to finance higher accounts receivable and inventory levels,
- extending trade debt to finance inventory and operational needs,
- refinancing or extending an existing loan to retain more working capital, and
- selling equity securities, e.g., common stock, to obtain permanent capital.

The questions to answer: What kind of return do I need to justify the cost of borrowing? How do I calculate that return? How do I maximize the total capital available to my business?

This advisory answers those questions whether you borrow new money or refinance an existing loan or sell equity-type securities. If you're not currently in the market to raise money, save this advisory for future reference. But read through it now to help you understand the mathematics of capital availability.

First, let's discuss the concept of earning power — your company's operating profit margin times its operating asset turnover. Your ability to use your company's operating assets to support and increase sales is critically important. The higher the turnover of those assets into sales, the higher your earning power and return on sales.

For example, let's assume your company's operating assets, principally cash, accounts receivable, and inventory, turn over into sales an average of 2 times a year. Now, with a 10% operating profit margin on each dollar of sales, your company's earning power (EP) is computed as follows:

$$\text{EP} = \text{Operating Asset Turnover} \times \text{Operating Margin}$$

$$\text{EP} = 2 \times 10\% = 20\%$$

That 20% is your true earning potential — your return or profit — on each dollar of sales.

There's a second concept to consider: the concept of average life. Let's start with a simple example: You want to borrow $100,000 from your bank to finance increased accounts receivable and inventory levels to support higher sales and thus higher profits (your EP). *Editor's note:* We intentionally used $100,000 so you can compute other loan amounts simply by multiplying the amount by factors, e.g., 1.5 for a $150,000 loan.

> ### This Report Helps You. . .
>
> - Calculate the real profitability of your business.
> - Determine whether you can afford a loan.
> - Estimate how much your company stands to profit from a loan.
> - Maximize the total capital available to your business.

Example of average life: When you borrow $100,000 for five years and repay it monthly, the *average life* of that loan is approximately half the total term of the loan — 2.5 years. Looked at another way, you have the use of the full $100,000 for an average of 2.5 years. The cumulative or total capital availability for the full five-year period is $250,000 — 2.5 average life times the loan amount of $100,000. (Total available capital is simply the loan amount times its average life.)

Now for a third concept. Let's assume you are paying an average of 12% interest (conservatively set high) and earning 20% on that money. Your incremental profit for the five years would be $250,000 times 8%, or $20,000. The 8% is your earning power of 20% less your cost of capital of 12%. The $250,000 is the $100,000 loan times its average life of 2.5 years. The profit can be further illustrated as follows:

$250,000 times 20% EP	$50,000
Less: $250,000 times 12% Interest	30,000
Incremental Profit (8%)	$20,000

This loan example is a typical scenario for most business loans. That $20,000 incremental profit on the $100,000 loan is called “profitable leverage” because your profits exceed the cost of borrowing. It’s a basic requirement if your loans are to make good business sense. *But there’s a way to significantly increase incremental profits on your loan*. It has to do with increasing the average life of the loan, i.e., the average amount of capital available for use by your business and the length of time for which it is available.

To illustrate the approach, let’s assume that your $100,000, five-year loan was repayable, not monthly, but at the rate of $20,000 annually at the end of years one through five. Now you have, on average, more available capital since you eliminated the monthly payments and extended or “stretched out” the loan repayments to the end of each year.

The result: The average life of the loan is now 3.0 years, not 2.5 years. Thus, the capital available to your business is $300,000 (3.0 times $100,000), not $250,000. *That’s 20% more capital availability.* And, if you redo the table on the prior page, you will see that your profits increased by the same percentage — your net earning power of 8% (20% less 12% interest) times $300,000 is $24,000, which is 20% more profit than the $20,000 profit you get with the loan repayable monthly.

The result is even more dramatic if you don’t have to repay any of the loan principal during the five-year period (e.g., you raise equity-type capital). Then the average life of the loan is the full five years, and the company’s *cumulative available capital* is $500,000 — $100,000 loan times five years.

Your profits are then:

$500,000 times 20% Earning Power	$100,000
Less: $500,000 times 12% Interest	60,000
Incremental Profit	$ 40,000

Your profits doubled compared with the $20,000 profit in our first example. That’s because the average life of the loan doubled, giving you twice as much capital to work with.

6 Ways to Increase Available Capital

Here are six ways to increase the average life of your loan and thus increase available capital and profits:

1. Extend the term of the loan, say, from 5 to 7 years. Assuming monthly repayments, that alone increases the average life from 2.5 years to 3.5 years — a 40% increase in available capital.

2. Delay commencement of repayment of the loan for a year or two. Referred to as a “moratorium of principal,” the effect is to push out the average life of the loan. (This concept is also referred to as a “bullet loan” in mortgage financings.)

3. Negotiate a “balloon” payment, payable at maturity — that’s generally limited to about 25% of the total loan amount.

4. Provide for an accelerating form of repayment, referred to as a *“step-up.”* For example, using our original $100,000, five-year loan (repayable monthly), let’s assume that the principal loan repayments were $10,000 in the first year, then $15,000, $20,000, $25,000, and $30,000 at the end of year five. Based on this repayment schedule, the average life of the loan increases from 2.5 to 3.5 years — 40% more capital availability. (See box on page 10 to calculate the average life of a loan using a step-up repayment plan.)

5. Negotiate what is called a five-year loan with a seven-year payout. Basically, the loan is due at the end of the fifth year, but the loan repayment schedule is structured as if it was a seven-year loan. Any remaining principal balance is payable at the end of the fifth year. *Example:* You borrow $200,000 for five years. The annual repayments are

Some Definitions

- *Operating profit* is your company’s profit *after* cost of goods sold and general, selling and administrative expenses. It is your profit *before* interest expense, nonrecurring or one-time income and expense items, and taxes.

- *Operating profit margin* is simply your operating profit divided by your sales (e.g., $100,000 operating profit divided by $1 million sales equals 10% operating profit margin).

- *Operating asset turnover* is your operating assets (cash, receivables, and inventory) divided into sales. *Example:* If your sales are $2 million and operating assets are $1 million, your asset turnover is 2.

- *Earning power* (EP) is your company’s operating profit margin times its operating asset turnover (e.g., 10% operating profit times 2 turnover equals 20% earning power).

- *Profitable leverage* is when your company’s earning power exceeds its cost of borrowing.

$28,571 ($200,000 loan divided by seven years) rather than $40,000 a year for a five-year loan. Thus, you have increased your available capital by $11,429 a year ($40,000 less $28,571) or a total of $57,145 for the full five-year period. *That's 29% more capital* ($11,429 more annual capital divided by $40,000).

6. Raise equity-type capital, such as common stock or preferred stock, where the schedule for repayment of the money can be indefinite. In the case of common stock, there is no repayment (company redemption); it's permanent capital. For preferred stock, the term can be 10 years or more with no repayments during the first five to 10 years. Keep in mind that the payment of dividends is usually required on the preferred stock and they are *not* tax deductible by the business as interest payments would be on loans and other debt securities.

There Are More Benefits

By increasing the average capital available to your business to finance increased sales and profits, you have also:

- Lessened your need to borrow more money in the future.
- Locked in a source of capital and its fixed costs (if the interest rate is not variable, e.g., a function of the prime rate).
- Increased your overall cash flow.
- Reduced the future costs of raising additional capital (i.e., your time, legal costs, points, finder's fees, etc.).
- Lowered the value of your repayments. *Reason:* You are stretching out the time period and thus paying back debt with cheaper dollars. (A $20,000 repayment in five years at a 3% inflation rate is worth only $17,260 today *— a discount of $2,740 or 14%.)*

Another example: Look at a $200,000, 20-year, 8% mortgage which has level payments, including interest and principal. At a 3% average inflation rate, your total principal repayments of about $20,000 in year 20 cost you only $11,000 in terms of *today's* dollars. Thus, the discount is $9,000 or 45%. That's why many individuals and businesses, particularly when interest rates are relatively low, take out the longest mortgage available; the principal repayments in the latter years of the mortgage are repaid with cheaper dollars.

Average Life vs. Interest Rate

How important is average life in comparison to the interest rate payable on a loan? Actually, it can be just as important. In fact, paying an extra percentage point of interest (e.g., 13% rather than the 12% in our $100,000 loan) is worth the added cost if you can move the loan's average life to, say, 5.0 years, rather than 2.5 years (i.e., $500,000 total available capital rather than $250,000). *Here's why.*

Paying one point more interest over the five years will cost $5,000 (1% times total capital availability of $500,000). But your profits will be much higher. You come out ahead by $15,000, an increase of 75%. Here's the math (top of next page), based on $500,000 total money available to the business ($100,000 loan times the average life of 5.0):

Incremental Profit Analysis for a $100,000 Loan

	Year 1	Year 2	Year 3	Year 4	Year 5	Available Capital
Average Capital Outstanding*	$90,000	$70,000	$50,000	$30,000	$10,000	$250,000
Earning Power (20%)	18,000	14,000	10,000	6,000	2,000	50,000
Interest Cost (12%)	−10,800	− 8,400	− 6,000	− 3,600	− 1,200	− 30,000
Incremental Profit	$ 7,200	$ 5,600	$ 4,000	$ 2,400	$ 800	$ 20,000

* $100,000 loan is repayable $1,666.67 per month ($20,000 annually); thus, on average, $90,000 is available in year one, $70,000 in year two, and so forth.

$500,000 times 20% Earning Power	$100,000	
Less: 12% Interest on $500,000	60,000	
Less: Extra 1% Interest (13% vs. 12%)	5,000	
Incremental Profit	$ 35,000	
Less: Prior Incremental Profit (See box on prior page)	20,000	
Increase in Profits	**$ 15,000**	**(75%)**

Thus, the loan repayment schedule is just as important as the interest rate you negotiate, particularly if your company has a high earning power and high need for future capital. However, be aware that an increase in the average life of a loan can increase your overall interest rate charges. But, as illustrated in the examples, that's okay if your EP is higher than the cost of borrowing.

More Ideas and Benefits

• *More profitability:* Your earning power informs you of your company's profitability. It also is a very good measure of how management is using the assets at its disposal. To increase sales and profits, pay close attention to the three components of your company's EP: your operating assets, sales, and operating profit margin on sales.

• *Current vs. fixed assets:* By analyzing your assets by category, you can more effectively determine where to invest new capital. As a general rule, always try to invest in operating assets, such as your receivables and inventory, because they have a much greater turnover than fixed assets. *Leasing fixed assets* — even at a cost of capital of 14% — and diverting the money to operating assets should yield greater profits than using that cash to buy fixed assets. Operating assets often have an earning power of 20%. (Of course, there is a point when fixed assets have to be replaced or acquired to allow for the company's growth.)

• *Cost vs. return:* On all new loan or refinancing decisions, always calculate how much interest you can pay to break even. For example, with an earning power of only 10% (say a 5% operating margin and a turnover of 2), a business would find it difficult to justify paying more than 10% for additional capital.

• *Equity capital:* As indicated in #6 on the prior page, one of the reasons in favor of raising equity capital by selling common stock is the concept of average life. Although you're giving away a piece of the business with the equity approach, which you aren't with a loan, you get 100% average life — in other words, you *never* pay back the money obtained in a common stock financing. Moreover, you don't have the fixed charges of interest and loan repayments or the burden of a loan agreement with its restrictive covenants.

Increase Capital by 40%: The "Step-Up" Repayment Schedule

As illustrated in this advisory, a $100,000 loan repayable monthly has an average life of 2.5 years — half the term of the loan since equal monthly repayments are being made. And, in effect, a business has the cumulative use of $250,000 — average life of 2.5 times $100,000.

In contrast, let's negotiate a "step-up" repayment schedule based on $10,000 at the end of the first year, then $15,000, $20,000, $25,000, and $30,000 at the end of years two through five. Based on this repayment schedule, here's how to compute the average life and the total capital availability.

Year	Loan Repayment	Capital Availability
1	$ 10,000	$100,000
2	15,000	90,000
3	20,000	75,000
4	25,000	55,000
5	30,000	30,000
	$100,000	$350,000

As calculated, the total available capital is $350,000 for the full five-year period. This amount, divided by the $100,000 loan, results in an average life of 3.5 years. That's 40% more capital availability compared to a $100,000 loan repayable monthly, which has total capital availability of $250,000 and an average life of only 2.5 years.

* * *

Increase your access to capital by using the techniques discussed in this advisory. Do your homework on your company's earning power before you approach a lender and place the loan repayment schedules near the top of your negotiating list. q

Referral Action

- q Treasurer
- q Bookkeeper
- q Accountant

Tax Compliance: Regulations and Deadlines

You have to be very precise and cautious in planning, preparing, and filing your personal and business tax information. Careful attention to deadlines, recordkeeping requirements, special forms, and substantiation rules will protect the deductions you claim and minimize your chances of IRS audits, questions, and disallowances. The price for sloppiness or oversights is higher taxes, interest, and penalties.

You also want to be up-to-date on tax areas in which the IRS has shown special interest and concern, as well as areas which have been the subject of recent court rulings. Of particular importance are deadlines for special elections, compliance with respect to 1099s, bonuses and compensation paid to owners/executives, the rules on charitable donations, and the deferral of income to another year.

This special advisory covers these subjects and presents other ideas to help you file timely and avoid IRS problems. Also, pay particular attention to the penalties for incorrectly classifying an individual as an independent contractor rather than an employee. The details are discussed on the next page.

Now to the IRS rules on filing Form 1099.

Form 1099 Requirements

Every business that makes payments of $600 or more to independent contractors and to other businesses for services must file information returns on IRS Form 1099 for the payments made.

Here are the requirements in brief form. Share this information with your treasurer, comptroller, bookkeeper, and/or accountant to assure compliance.

Due Dates

- To the recipient — Jan. 31, 2002
- To the government — Feb. 28, 2002 or Mar. 31, 2002 if filed electronically

When Is a 1099 Required?

Any time you pay out:

- Interest of $10 or more: Form 1099-INT.
- Dividends of $10 or more: Form 1099-DIV.
- Compensation of $600 or more to independent contractors: Form 1099-MISC.
- Rents, fees, commissions, prizes, and awards to non-employees of $600 or more: Form 1099-MISC.
- Royalties of $10 or more: Form 1099-MISC.
- Distributions from any company pension or profit-sharing plan: Form 1099-R.

What about fees for medical and legal services paid to doctors and lawyers? If the amount is $600 or more, you must file 1099-MISC even if the doctor or lawyer operates under a PC, professional corporation.

Penalties on 1099s

If you made a mistake or didn't file a 1099 when it should have been filed, here are the penalties.

- Omission of the recipient's ID# is $50 for each omission.
- $50 for each 1099 not filed ($100 for intentional failure to file) *plus* $50 for failure to provide the form to each individual who was to receive a 1099. In some cases, the penalty can be higher, e.g., 10% of the amount that was to be reported on the 1099.
- In addition, there are more severe penalties if the IRS reclassifies an independent contractor as an employee; that's discussed on the next page (bottom right), *Penalties for Improper Classification.*

Know the Rules on. . .

- q Filing Dates and Forms to Use
- q Receipt of Cash
- q Real Estate Sales
- q Use of Magnetic Media
- q Penalties for Noncompliance
- q Employee or Independent Contractor Status

Other Form 1099 Alerts

1. *Mortgage interest:* You must report mortgage interest of $600 or more received from an individual. Use Form 1098.

2. *Corporate services:* In general, you do not have to file Form 1099 for payments for services, rents, etc., made to a corporation. However, as previously indicated, payments made to businesses or individuals that performed legal services for the company or medical services (e.g., when your business pays an employee's medical expenses) do not come under this exemption; the payments must be reported on a 1099.

3. *Receipt of cash:* If, in connection with your business, you receive more than $10,000 in cash in one or more related transactions, you must file Form 8300, *Report of Cash Payments Over $10,000 Received in a Trade or Business*. The requirement applies to the receipt of cash for the purchase of services, real or personal property, a debt obligation paid for with cash, and the receipt of cash to be held in escrow.

In addition to filing Form 8300 with the IRS, you must send a statement to the payor of the cash by Jan. 31, 2002. There are civil and criminal penalties for failing to file this form. Check with your accountant on any significant cash transactions.

4. *Real estate sales:* Real estate sales have to be reported on Form 1099-S, whether the seller is a company or individual. Generally, the person responsible for closing the transaction is also responsible for filing the 1099-S; that's usually an attorney. If you've had real estate transactions in 2001, check with your lawyer or accountant to be sure Form 1099-S is filed with the IRS by Feb. 28, 2002 and sent to the other party in the transaction by Jan. 31, 2002.

5. *Magnetic media:* You have to use magnetic media if you file more than 250 forms of 1099-DIV (dividend payments) or 1099-INT (interest payments), or more than 250 1099 MISCs or W-2s. The penalty for noncompliance is $50 per form.

Any questions on Form 1099? Talk to your accountant or request Form 1099 from the IRS (www.irs.gov). It contains and explains all of the filing requirements.

Independent Contractor Cautions

Don't try to use a 1099 to qualify someone as an independent contractor who is really an employee.

Is That Independent Contractor a Company Employee?

The use of independent contractors is one of the best ways to reduce payroll costs, fringe benefit expenses, and Social Security and Medicare taxes. Unfortunately, the IRS is also well aware of this and of the desire of owners to provide independent contractor status for as many workers as possible. Therefore, the legitimacy of your independent contractors frequently is at the *top of the list* in a tax examination.

According to many tax experts, here are the principal guidelines the IRS uses to distinguish between an independent contractor and an employee.

Independent Contractor Status — Is paid for a specific job • Sets own hours • May work for others • Engages own assistants • Offers services to the general public • Furnishes own tools • Can earn a profit or have a loss • Establishes the order and sequence of work • May perform the work elsewhere.

Employee Status — Relationship is ongoing • Follows instructions • Works for one employer • Can be fired • May quit without any liability • Receives reimbursement for expenses • Is trained by the employer • Is an integral part of the business' overall operations.

Penalties for Improper Classification

If the IRS can prove that an independent contractor was really an employee of the company, here's what may happen on penalties.

1. If you filed a 1099

• Penalty is 1.5% of total paid wages *plus*

• 20% of the total FICA taxes that should have been withheld.

2. If you did *not* file a 1099

• *Inadvertently:* Penalty is 3% of total paid wages plus 40% of the FICA tax; that's double the amount above.

• *Intentionally:* Penalty is 100% of all the taxes that should have been withheld (both income and FICA) plus the employer's portion of FICA.

The IRS is always on the lookout for employers who try to avoid the payroll taxes and other liabilities involved in hiring employees.

Matching program: Be forewarned that the IRS has a *matching program* in place. If an individual's total gross receipts (Schedule C, Self-Employment Income) match only one 1099, there's a good chance that that individual (and you) may be audited. Basically, that independent contractor is indicating that he or she worked *only* for you. If the IRS does classify that independent contractor as an employee, even though you filed a 1099, the penalties can be significant; see prior page.

Get written confirmation: Even where a relationship has all the earmarks of an independent contractor, the IRS may raise a challenge. Although it doesn't guarantee protection, consider getting the independent contractor to sign a written agreement indicating that he or she is an independent contractor and listing the reasons. However, be aware; a *written* contract stating the worker is an independent contractor will not save you if the majority of the relationship smacks of employee status.

Other Ideas and Cautions

Earned income tax credit for employees. Employers are required to notify their employees (other than students) that they could be eligible for the earned income tax credit available to low-income employees with children. Be sure you do so. *Editor's note:* If you or your employees wish additional information on the earned income credit, call 800-TAX-FORM or visit the IRS Web Site at www.irs.gov; request IRS Publication #596.

Form W-4 compliance. If your or an employee's tax situation changes this year because of a dramatic change in your income or deductions, be sure a *new* Form W-4 is filed to adjust the tax withholdings. If your tax liability is expected to be less than withholdings, you can increase the number of exemptions. If you expect to be under-withheld, decrease the number of exemptions. *Other facts:*

- All new employees must complete Form W-4.
- If an existing or new employee doesn't complete Form W-4, the employer is required to withhold taxes on the basis of a single taxpayer with zero withholding allowances.
- Employers must report to the IRS the names of employees who claim 11 or more exemptions.
- Retain copies of all W-4s; you will need them if your company is audited. Form W-4 compliance is one of the first areas checked by the IRS.

Estimated taxes for 2002: As a general rule, your 2002 personal tax withholdings must be at least 90% of this year's estimated taxes or 100% of last year's taxes, whichever is less. For taxpayers with income above $150,000 for last year, their estimated taxes for 2002 must be at least 112% of last year's tax bill.

Alert: You may wish to circulate part or all of the above advisory to your employees.

Charitable contributions. Contributions of $250 or more require extra documentation, i.e., a written acknowledgment from the charity; canceled checks alone are not sufficient substantiation.

For *non-cash* gifts of more than $500, you must file Form 8283 with your tax return. If the gift exceeds $5,000 in value in any one year, an appraisal of the property is required. *Be careful:* The acknowledgment/verification from the charity must be received by the taxpayer *before* the tax return is filed, not after an IRS inquiry or audit of that year's tax return.

Caution on deferring income. If you have deferred or are thinking of deferring income or bonuses, keep in mind that the IRS requires any deferred compensation agreement to be entered into *prior* to the time the services are performed. That means that the IRS could argue against deferral for compensation paid after yearend that really relates to services performed during the prior year. This also applies to any compensation or bonuses accrued for non-owner executives.

Proof of mailing. Don't use a postage meter or stamp. It's wise to send all tax correspondence to the IRS by certified mail, return receipt requested. The cost is nominal. That way you will have a record of the date mailed and when the IRS or state agency received it.

Here are two other reasons: Using certified mail is important (a) if you're sending a tax election that has firm deadlines (e.g., election of S corporate status, which must be filed by Mar. 15, 2002) or (b) if the IRS has assessed interest and penalties and you want a record of the date of mailing to stop these charges from accumulating. Anticipate mail delivery dates and build in a time cushion to meet deadlines. As a general rule, timely mailing is timely filing. *(More. . .)*

Statute of limitations. The IRS can go back three years to question a tax return. You also have three years to amend a return. *Caution:* If there was an understatement of income (25% or more), the IRS can go back six years. If there's fraud, it can go back indefinitely.

Converting Taxes to Cash

Three cash-generating actions: (a) If you have overpaid your 2001 corporate estimated taxes, have your accountant file IRS Form 4466 to claim the refund; (b) if you had a loss for 2001, you can carry back that loss against the taxes you paid for the prior two years and get a refund of some of these taxes, use Form 1139; and (c) if you anticipate a loss for this year, lower your estimated tax liability and quarterly payments by filing Form 1138.

* * *

Mark Your Calendar for Important Tax-Filing Dates, please see below. q

Mark Your Calendar for Important Tax-Filing Dates

Have your secretary set up a tickler system to remind you of the following important filing dates.

- q *IRAs:* For an IRA deduction, the papers must be filed by Apr. 15, 2002 *and* the contribution made by that date; tax extensions are not allowed.
- q *Keoghs:* For a Keogh deduction, you must have filed the papers before Dec. 31, 2001 and make your contribution by Apr. 15, 2002 or Aug. 15, 2002 with a tax-filing extension.
- q *Estimated taxes (personal):* For year 2002, your quarterly estimated taxes are due on Apr. 15, June 15, and Sept. 15, 2002 with the final fourth-quarter taxes due on Jan. 15, 2003.
- q *Estimated taxes (corporate):* To the IRS on Apr. 15, June 15, Sept. 15, and Dec. 15, 2002.
- q *Form 1099:* Mail to the recipients by Jan. 31, 2002 and to the IRS by Feb. 28, 2002.
- q *Form W-2:* Mail or distribute to employees by Jan. 31, 2002 and Forms W-2 and W-3 to the Social Security Administration by Feb. 28, 2002.
- q *Payroll:* File Form 941 by the end of the month following each quarter.
- q *Tax return filings:* For individuals, partnerships, and limited liability companies, to the IRS by Apr. 15, 2002 or July 15, 2002 (Aug. 15, 2002 for individuals) with the automatic tax-filing extension. For C and S corporations, by Mar. 15, 2002 or Sept. 15, 2002 with the automatic extension.
- q *Other tax filings:* Gift and trust returns by Apr. 15, 2002. File any estate tax return within nine months after the death.

S corporate election: If you want to elect S corporate status for Year 2002 tax treatment, you must file the papers by Mar. 15, 2002. Use IRS Form 2553 and obtain the signatures of all stockholders.

Switching rules: Once you switch from an S corporation to a C corporation, you usually must wait five years before switching back to an S corporation. In contrast, there is no waiting period if you switch back from an S to a C corporation.

Tax ID number: When employing independent contractors this year, obtain their Tax ID Number (TIN) before paying them. q

How Much Key-Executive Life Insurance Do You Need?

Question. I own 100% of my company, which has annual sales of about $3 million. There are two important executives whose lives I want to insure; they are *very* important to the success of our company. Are there any formulas for determining the amount of life insurance I should get on each executive?

Answer. Yes. When deciding how much insurance to purchase, you must first determine why the life insurance proceeds are needed and then **try to quantify** the amount of coverage needed. It's not a very complicated process. In fact, in many cases, a good *guesstimate* on how much insurance is needed can be made by the business owner with his/her insurance adviser and accountant. Here are three methods you can use for the calculations.

Method #1. *Capitalized salary of key person:* Since the executive's salary is presumed to be based on his or her value and contribution to the company, you can use an amount equal to three times the annual salary to determine the coverage needed. *Example:* If his salary is $80,000 a year, $240,000 life insurance is needed.

Another method: If the key executive is a salesperson who generates revenues or commission income of, say, $100,000 a year, multiply that figure by two or three years, for a total insurance need of $200,000 to $300,000.

Method #2. *Executive's contribution toward company earnings or its value: First,* average your company's operating profits over the last three years — say, $100,000. *Second,* multiply the average profits by three years and calculate the income that total amount would have earned if it had been invested at a reasonable rate of interest — say, $300,000 capital invested at 10%, yielding $30,000 annually. *Third,* estimate the "excess" earnings by subtracting the average profits from the interest earned on capital ($100,000 less $30,000 equals $70,000). *Fourth,* estimate how much of the earnings can be attributed to the key executive you want to cover, say, 50% of the $70,000. *Fifth,* multiply the resulting $35,000 by the number of years you wish to cover. If it's five years, then $175,000 of life insurance is needed on that executive's life.

Another method: Estimate the value of your company, say $800,000, and apply a percentage for the key executive's contribution to that value. If it's 25%, you need $200,000 of life insurance.

Method #3. *Replacement cost: First,* figure out how much additional salary is being paid the executive over and above the pay for his or her routine duties. For example, if his salary is $80,000 but the routine part of the job accounts for $20,000, his extra abilities are worth $60,000. *Second,* estimate how many years it would take to fully train a successor to be as productive as the executive currently is; let's say three years. *Third,* multiply the above two factors: $60,000 × three years = $180,000 life insurance.

To recap, here are the amounts of life insurance coverage needed to protect your company:

#1.	Capitalized Salary	$240,000
#2.	Contribution to Earnings/Value	175,000
#3.	Replacement Cost	180,000
	Total of Three Methods	$595,000
	Average Life Insurance Needed	$198,333

Agency fee: To the above methods, you can add $10,000 to $25,000 for the fee charged by an employment agency to locate a new executive.

Summary: No one method is best; consider using a combination or average of the above three methods. Only you can really evaluate the potential financial impact on your company of a key executive's death or your own death.

Policy options: Ask your insurance agent about split-dollar insurance whereby cash equity is built up in the policy. The executive can keep the insurance policy if he or she leaves the company; you keep the cash value. In contrast, if cost is a concern, use term insurance. q

***The best approach:* Calculate the protection you need using all three methods, then average them for your final dollar number.**

15 Ways to Reduce and Effectively Use Premium Outlays

The payoff for careful insurance planning can be considerable. When you reduce a premium, it's not *a one-time reduction*. The savings accumulate over all the years of coverage. On $10,000 of annual premium payments, a 20% savings of $2,000 that you implement today delivers $20,000 savings over 10 years and $40,000 over 20 years. And those savings are in addition to the interest earned by the money that's now in your pocket, not the insurance company's.

Here are 15 ideas to help you maximize the impact of your premium expenditures.

Personal Ideas

#1. Reduce the amount of your life insurance if your need to protect dependents has declined or restructure its use, e.g., use a personal policy for business purposes, such as a buy-sell agreement, or designate your grandchildren or a charity as the beneficiaries instead of your grown children.

#2. If you're in good health, push for a *preferred rating* on new policies; the premium is substantially lower for each year the policy is in force. Furthermore, don't smoke. The added premium cost for smokers can be as high as 30%.

#3. Consider replacing old life insurance policies with new lower-cost term, whole life, variable, or universal life insurance policies but only *after* you determine the annual net cost of the older policy. You don't want to cancel a policy whose annual premium is completely offset by the dividend and increase in the policy's cash value. Also, don't replace or cancel an existing policy until the new policy is issued just in case the new insurer finds you uninsurable or will only issue a rated policy with a higher annual premium.

#4. Minimum deposit your life insurance if your cash flow is tight. That involves using your dividends and the policy's cash value to pay some of the premium. But be careful. Remember that policy loans must be repaid, including interest, or the amount owed will be subtracted from the death proceeds.

#5. Consider lower-cost, second-to-die life insurance on your and your spouse's lives to provide for your children and pay federal and state estate taxes if that's a potential problem.

#6. If you need more short-term life insurance to provide for children until age 21, consider buying inexpensive term insurance. But make sure the policy is convertible to whole life just in case you need the insurance in future years for another use.

#7. Refrain from buying credit or travel life insurance. The same amount of premium can buy you more permanent coverage in other policies.

#8. Take maximum advantage of your policies' dividends. Collect them in cash, buy more life insurance if that's an option, or use them to reduce your annual premium.

#9. If you're *under*-insured or have a limited amount of money to pay premiums, buy inexpensive term or savings bank life insurance if it's available in the state where you reside. You can convert the term insurance to a whole life policy later if the need for the insurance becomes permanent.

#10. Lower disability premiums by increasing the waiting period to receive monthly benefits, but be sure you have the extra cash to ride out the waiting period.

Business Ideas

#11. To lower business insurance costs, look into split-dollar insurance for you and executives so your company is reimbursed for all or most of the premiums it pays.

#12. Don't *over-insure* key executives; use a formula of three to four times their annual salary. See article on page 15.

#13. Have your company pay any premium for insurance coverage which is tax deductible. *Example:* Life insurance in retirement plans.

#14. Use first-to-die life insurance to fund a buy-sell agreement covering more than one owner's life. It's usually less expensive than two or more whole life insurance policies.

#15. Be careful of buying on-line life insurance without obtaining an illustration of the annual projected premium cost, dividends, and increase in cash value. Then review the illustration with your life insurance agent and accountant to determine the net cost of the insurance.

Finally, on all new policies, shop around; get comparative cost data. The life insurance market is very competitive. But do select insurance companies with excellent industry ratings and comparatively high investment returns.

What to do: The ideas are numbered; check off those ideas which are applicable to you, your family, and business. Then call your life insurance agent, accountant, and estate planner to discuss them. And feel free to copy this advisory to share with them. q

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CATS: What Are They and When Should They Be Used?

Question. My investment broker recommended that I purchase some CATS for my IRA and corporate retirement plan. Would you recommend this investment and give me some details?

Answer. We do not give specific investment advice, but we will explain CATS and define some of the other government-related securities.

CATS are "Certificates of Accrual on Treasury Securities." They are purchased at discounts from 20% to 90% of the face value. *Example:* You buy a CAT for $400 which has a $1,000 redemption value at maturity. The $600 difference is the interest (return) paid to you at maturity. CATS are similar to U.S. Treasury Bills but Treasury Bills have maturities of less than one year.

Some characteristics of CATS:

- CATS represent a claim on the U.S. Treasury so they're considered relatively safe investments.
- CATS usually offer yields competitive with other U.S. government securities.
- Maturities, which range up to 30 years, and discounts on CATS vary to suit an investor's specific needs.
- CATS afford the opportunity to purchase an investment with a large redemption value at a relatively low initial cash outlay.
- There is a good secondary market, so the securities are marketable after purchase.

Some cautions: First, because of the big discount off the redemption value and changing interest rates, the price of CATS can be more volatile than that of regular bonds. Thus, if interest rates increase substantially after the date of purchase, the value of a CAT can decline substantially. And, vice versa, if interest rates drop, the value of your CAT will increase since your built-in yield on the CAT is greater than what the market is paying currently on interest-sensitive investments.

Second, there is no *current* interest income since the investor's return is paid in full at maturity; thus, a CAT is not a suitable investment if you need current income.

Third, the annual increase in value (i.e., the interest accrued each year) is taxable income annually even though the interest is not received until maturity or when the CATS are sold. That's why CATS are an appropriate investment vehicle for IRAs and other qualified retirement plans, which do *not* pay current taxes on any growth and shelter all earnings from taxation until the retirement money is withdrawn.

Other government securities to consider:

TIGERS	Treasury Investment Growth Receipts
COUGARS	Certificates of Government Receipts
ETRS	Easy Growth Treasury Receipts
TINTS	Treasury Interest Notes

Some observations: (a) the two most actively traded government securities are TINTS and CATS; (b) the maturities of government securities range from 1 to 30 years; and (c) the yields among the securities are about the same; however, longer-term maturities generally command a higher interest rate, as with most long-term bonds.

Editor's note: Talk to more than one adviser about the applicability of CATS and other government securities to your retirement plan and personal portfolio. And, if you're concerned about the direction of interest rates, stay with the shorter maturities since the price volatility is less than with longer-term bonds. q

Index of 2001 Articles, Reports, and Case Studies

Here is a listing by subject area of the major articles, advisories, reports, and case studies which appeared in the 2001 issues of THE BUSINESS OWNER. Issue months are listed by initials (e.g., J/F is January/February). To order individual 2001 issues, please see the next page. (*Note:* Sometimes an article is included in more than one subject category.)

For You, Your Family, Your Business

Insurance and Protection. How to Protect Insurance Proceeds from Becoming Taxable Income (J/F, pg. 8) • Business Indemnification (M/A, pg. 6) • *For Owners and Key Executives:* Reasons to Consider Split-Dollar Insurance (M/J, pg. 9) • Use Caution When Buying Term Insurance (J/A, pgs. 3-4) • How to Protect Against Disability (J/A, pg. 11) • How to Use a Salary Continuation Plan (J/A, pg. 20) • A Guide for Getting Your Life Insurance in Order (N/D, pgs. 11-14)

Investments. What Investment Expenses Are Tax Deductible? (M/A, pg. 3) • Investing for the Short or Long Term (M/A, pg. 5) • The Power of Tax-Deferred Compounding Within and Outside Retirement Plans (M/A, pg. 9) • Have Your Assets and Investments Kept Pace with Inflation? (M/J, pgs. 18-19) • Investment Facts and Strategies to Use Today (M/J, pg. 20) • How to Compute Discount and Yield on T-Bills (J/A, pg. 3) • How to Compute Equivalent Yield on Tax-Exempts (S/O, pgs. 4-5) • How to Evaluate Real Property Investments (N/D, pgs. 15-18)

Ownership. How to Protect Against Misuse of Business Ownership (Ways to Protect Owner and Company When Giving, Transferring, or Selling Stock or Options to Family Members, Company Employees, and Outsiders) (S/O, pgs. 7-9) • Sample Investment Letter for Buyers to Sign (S/O, pg. 20)

Pension Plans. Use of Salary Reduction Plan (J/A, pgs. 11-12) • Use of SIMPLE and SEP Plans (J/A, pgs. 12-13) • Rules on Borrowings, Prohibited Transactions, and Role as Trustee (N/D, pg. 4)

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Steering Clear of the IRS: Special Alerts for Business Owners

No one can guarantee that you'll never run into questions from the IRS. A certain percentage of returns still are selected by random each year for examination or audit.

What we can tell you is that care in the following areas will strengthen your position if and when the IRS knocks on your door.

q Be diligent on *both* your personal and business recordkeeping. Poor records and noncompliance in one area can cause an audit of both areas.

q Prepare detailed, complete meeting minutes and keep them current throughout the year.

q Establish *written* company policies requiring all employees to provide full documentation of expenses with receipts within 30 days of their occurrence and don't authorize any expense reimbursement until you have documentation.

q Demand that each employee keep a mileage log on auto use that indicates the business and personal use for each trip, as well as the date and reason for the auto use.

q Keep contemporaneous records on all expenses; the IRS has ways of spotting records reconstructed *after* an IRS inquiry or audit has begun.

q Be sure the value of *personal* use of company property, particularly autos, is reimbursed by each employee or is reported as income on their W-2s.

q Make clear in writing and in corporate minutes which officer or employee in your company is responsible for *timely* filing of payroll, sales, and estimated income taxes, as well as Forms 1099 and W-2s, and Forms W-4 for new employees. Establish a procedure for checking that such filings are done on schedule. *Note:* For filing requirements, please see *Tax Compliance:* Regulations and Deadlines, on pages 11-14.

q Report all income to the IRS, the personal use of company autos and other taxable benefits. Remember also, the IRS receives copies of statements from employers, banks, brokerage firms, and other financial institutions that it uses to verify the income you report.

q Document all owner and inter-company contract transactions, particularly sales, advances, and loans, with affiliated businesses owned by the company or its stockholders.

q Don't intermingle business receipts and deposits with personal accounts.

q Place on the company's payroll as employees those independent contractors whose activities you control, where the relationship is ongoing, who are an integral part of your company's overall operations, and particularly those who work solely for you. For the criteria used by the IRS in determining employee or independent contractor status, please see *Is That Independent Contractor a Company Employee?* on page 12.

q Obtain board approval on all money and contract transactions between the company and you and other family members.

Free Information to Help Understand the Rules

To further familiarize yourself with the rules, the following *free* booklets are available from the IRS:

334 – Tax Guide for Small Business • 463 – Travel, Entertainment, Gift and Car Expenses • 535 – Business Expenses • 550 – Investment Income and Expenses • 551 – Basis of Assets • 552 – Recordkeeping for Individuals • 561 – Determining Value of Donated Property • 587 – Business Use of Your Home

How to order: Call 800-TAX-FORM or visit the IRS Web Site at www.irs.gov. q