

Trendlines

New Directions in Business and Personal Planning



Show some GRATitude

Low interest rates make now a good time to consider this trust type

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Taking a second look at 529 plans

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More companies tracking Internet use, many 401(k) plans lack diversity ...



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Show some GRATitude

Low interest rates make now a good time to consider this trust type

Like most business owners, you probably want to show your family some gratitude for their devotion and support over the years. And sharing some of your hard-earned wealth while you're still around to see them enjoy it is one way to do so.

But you likely also wish to keep receiving some income and may fear how well your children would handle a highly valuable asset. You might have a wary eye on Uncle Sam's gift tax, too. That's a lot to keep in mind, but you can do it all — with a grantor retained annuity trust (GRAT). And with today's low interest rates, this trust type offers a great opportunity.

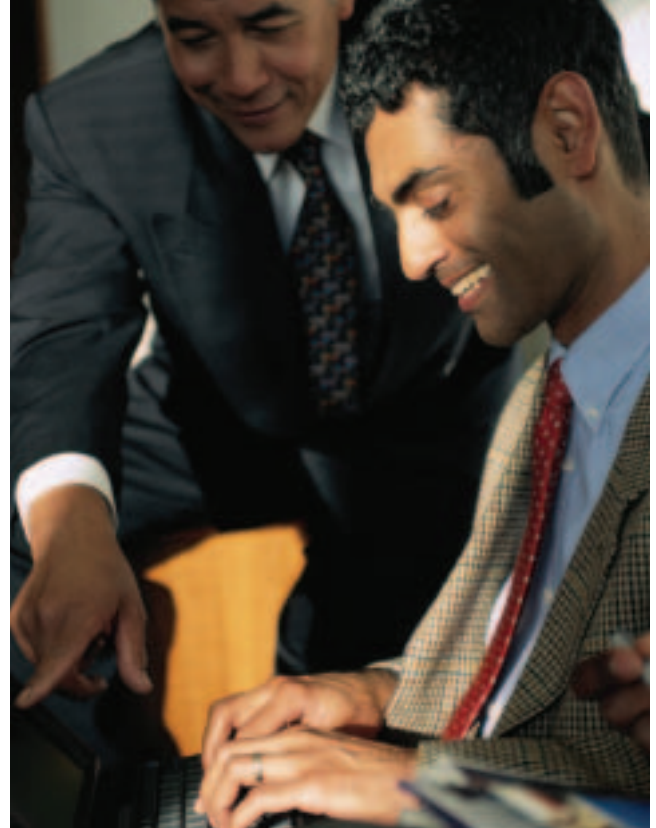
The ins and outs

With a GRAT, you (as the grantor) create an irrevocable trust to which you make a substantial gift today and then receive income from it for a specified period.

Doing so enables you to:

- ☐ Transfer (without surrendering control of) income-producing assets to your children or other heirs,
- ☐ Receive income from those assets during the trust's term, which can be any number of years, and
- ☐ Discount the assets' value for gift tax purposes if you are transferring a minority interest to the trust.

More specifically, a GRAT pays you an annuity expressed as a percentage of the value of the assets transferred to the trust. (The minimum annual payout is 5%.) You can, for example, use this income to live on until you reach the age at which you begin taking



retirement plan distributions. Or you may want to use it to supplement existing retirement funds.

Bear in mind, the trustee must pay the annuity whether or not the assets generate income. So if the assets don't earn enough to do so, the trustee will have to use principal. And once you initially fund the GRAT, you can't make additional contributions. At term's end, the trustee either distributes the assets outright to the beneficiary or continues to hold them in trust for the beneficiary, according to the wishes you spelled out in the trust document.

Uncle Sam's bite

Assets transferred to a GRAT *do* trigger a gift tax, because you're giving something to a beneficiary. And they *don't* qualify for the \$11,000 annual gift tax

exclusion, because they're not gifts of a "present interest." On the bright side, you can use a portion of your \$1 million lifetime gift tax exemption.

The gift tax is assessed based on the present value of the remainder interest that is expected to go to the beneficiary. The gift tax is determined by first discounting the value of your annuity payments using the Section 7520 rate, which the IRS publishes monthly on its Web site (www.irs.gov). The remainder interest's present value is calculated by subtracting this income stream's present value from the value of the assets on the day you transferred them.

The good news is that the Section 7520 rate is tied to interest rates. Despite rising somewhat from recent record depths, these are still very low. And the lower the Section 7520 rate, the higher your annuity's value will be and the lower the remainder's present value (on which you pay gift tax). A 6% annuity is worth more when the assumed interest rate is 4% than when it is 5%. Plus, you'll never pay another dime of gift tax on the assets you placed in the GRAT — so the more they appreciate, the more you'll save in taxes.

GRATs provide the greatest tax benefits when their assets appreciate quickly.

Because of these considerations, GRATs provide the greatest tax benefits when their assets appreciate quickly. So, to the extent possible, transfer assets to the trust you expect to appreciate significantly over its term. These may include stock (especially shares in a closely held business that could go public during the trust term) or real estate.

Hillary's sweet deal

Here's an example of how a GRAT might work for a business owner. Hillary has a successful lawn and garden supply company that she expects to grow



20% annually for the next five years. The business is worth \$2 million and she wants to transfer 25% of it to a GRAT, taking an annuity for five years that is large enough to bring the gift's value close to zero.

To get started, Hillary must have the asset she's putting in the GRAT valued. For instance, though 25% of a \$2 million business equals \$500,000, the 25% interest may qualify for a discount because it's receiving a minority interest. If this discount is 40%, the value of the asset itself would drop to \$300,000. Still, meeting her goal of establishing an annuity to reduce the gift's value to near zero will depend mainly on the Section 7520 rate.

For simplicity's sake, let's say she'll receive a \$75,000 annuity — totaling \$375,000, or 125% of the discounted value, over the five-year period. If all goes well, her business will earn enough in annual net income (in this example, exactly 15% of its nondiscounted value) to pay this amount. Plus, she'll eventually transfer 25% of a \$2 million company without paying gift tax or using her lifetime exemption. Moreover, 25% of future appreciation in the business will also escape gift tax, because Hillary is making the gift now. The actual financial impact of the gift, however, is delayed for five years because the trust keeps little or no cash flow while paying the annuity.

Your life, your estate

Remember, transferring assets to a GRAT will be ineffective for estate tax purposes unless you outlive the annuity term. If you don't, the assets will be included in your estate for estate tax purposes. Please call us to discuss how to make the best choices on GRAT terms and structure. □



A luxury no more

Outsourcing can benefit companies large and small

For many years, owners of small and midsize businesses looked at outsourcing much like some homeowners viewed hiring a cleaning person. That is, they saw it as a luxury reserved for those who could afford “hired help.” But no more — outsourcing is fast becoming a common way to cut costs while maintaining focus in an increasingly complex world.

Why would you?

Why go through the hassle of outsourcing tasks that your company has been handling all along? Well, let’s begin with cost savings. Outsourcing a function effectively could save you at least 20% of its in-house management expense by reducing overhead, staffing and training costs. And thanks to the bumpier economy and a more “humble” technology sector, many providers are now charging significantly less than in previous years.

Outsourcing also allows you to leave administration and support tasks to someone else and focus your attention on your company’s core purpose. Plus, the firms that perform these functions are specialists, offering much higher service quality and greater innovations and efficiencies than you could likely muster. Last,

think about accountability — vendors will be able to explain the laws, processes and reasons behind their specialties in much greater detail than you probably can. This may help you more quickly resolve conflicts with employees and governing agencies.

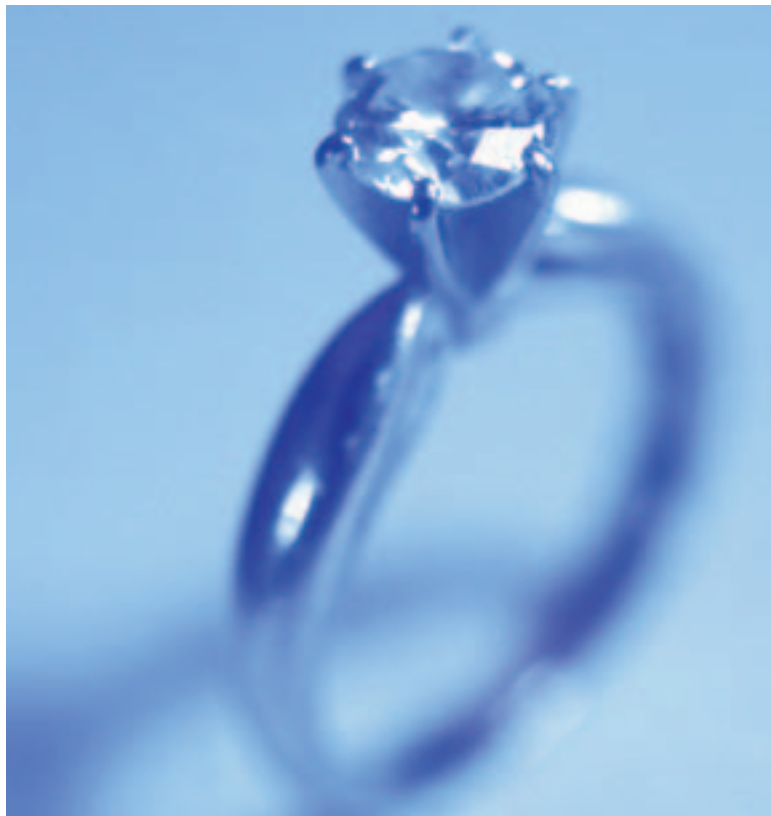
What’s the catch?

Of course, potential disadvantages exist as well. Outsourcing a business function obviously means surrendering some control of your personal management style in that area. Some business owners and

executives have a tough time with this. Another issue: Integration — every provider may not mesh with your company’s culture. A bad fit may lead to communication breakdowns and other problems.

Also, in rare cases, you may risk negative publicity from a vendor’s actions. Recall the well-publicized brouhaha over shoe-maker Nike out-

sourcing its manufacturing to third-world countries and paying workers substandard wages. Or, more recently, Wal-Mart suffered bad press when authorities caught a subcontractor hiring illegal aliens.



3 acronyms: An outsourcing glossary

Outsourcing providers are a diverse bunch, ranging from large firms equipped with ranks of employees to solitary souls who stand ready to simplify the lives of busy executives. Here are three common outsourcers — and acronyms — you may encounter:

- 1. Application service providers (ASPs).** These technology firms invest in expensive network file servers and rent a portion of these machines' capacity to you (usually via the Internet). They also may offer custom software, online and in-person training courses, and off-site data storage.
- 2. Professional employer organizations (PEOs).** You partner with this type of provider, which essentially becomes a “co-employer” that manages and administers payroll and HR functions. It contractually assumes significant employer rights, responsibilities and risk — including compensation, benefits, unemployment issues and even termination.
- 3. Virtual assistants (VAs).** These are typically stay-at-home workers who offer administrative services such as word processing, data entry, bookkeeping and event planning. They can be ideal for small-business owners who run fast-growing companies but don't want to formally hire someone.

To protect yourself, stipulate your needs in the contract. Pinpoint milestones you can use to ensure deliverables produced up to that point are complete, correct, on time and within budget. And don't hesitate to tie partial payments to these milestones and assess penalties or even reserve the right to terminate if service falls below a specified level. Last, build in clauses giving you intellectual property rights to any software or other items a provider develops. After all, you paid for it.

Where to begin?

Now that you know a little about the benefits and dangers of outsourcing, you're probably wondering what areas of your business a vendor could take off your hands. Well, IT is the most obvious and time-tested choice. Bringing in an outside firm to handle your systems can provide all the benefits we've mentioned — particularly in the sense of keeping you on the cutting edge. A competent technology provider will stay on top of the latest applications for your business as well as help you better access, store and protect your data.

What else can you farm out to harvest more savings? Well, payroll and other HR functions, for starters. These areas' many complex, applicable laws change

frequently — as does the software needed to track and respond to the revisions. A worthy vendor will be able to not only handle these challenges, but also give you and your staff online access to payroll and HR data that allows employees to get immediate answers to their questions.

Outsourcing also allows you to leave administration and support tasks to someone else and focus your attention on your company's core purpose.

Another possibility: customer service. This may seem an unlikely candidate because you might believe that, for someone to represent your company, he or she must work for it. But this isn't necessarily so — customer service reps have a high turnover rate, which drives up the costs of maintaining these departments internally and drives down customer satisfaction. Outsourcing to a provider with a more stable, loyal staff can make everyone happier.

Last, but certainly not least, consider bringing in outside experts to handle your accounting. A reputable

A competent technology provider will stay on top of the latest applications for your business as well as help you better access, store and protect your data.

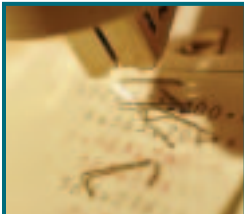
vendor can manage your books, collect customer payments and pay suppliers. The first two years it went this route, oil giant BP saved 26% thanks to a more efficient back office.

Who can help?

Before you outsource anything, assemble a team of financial advisors, managers and key employees to assess your needs. Bear in mind, this isn't just a



“dollars and cents” decision — one of outsourcing’s biggest benefits is the intangible value of not having to worry about certain business functions. So please call us; we’d be happy to be on your team and help you evaluate the pros and cons of this important choice. □



Moneylines: News briefs for businesses and individuals

Is your company big brother or permissive parent? A vast majority of companies are keeping an eye on their workers’ Internet use, says a recent study by Bentley College’s Center for Business Ethics. In fact, 92% track employees’ e-mail and surfing habits — with 26% doing so constantly rather than only when an issue arises. If you count your business among these vigilant ranks, consider implementing a formal monitoring program that balances your concerns with workers’ privacy rights.

Vacation homes aren’t always a day at the beach. The post-holiday doldrums might get you thinking about a getaway. And what better way to cut your costs than investing in a vacation home and then renting it out when you’re not around? Not so fast — because rents haven’t increased as fast as property values, rental revenue may provide only 5% to 6% of your purchase price. And you stand to lose up to 25% more in management expenses. So be prepared to buy carefully, advertise heavily, refurbish regularly and kick in some extras.

New standard mileage rate benefits more companies — sometimes. The IRS has boosted the 2004 standard mileage rate for cars, vans, pickups and panel trucks from 36 cents a mile to 37.5 cents. Plus, businesses that use four or fewer vehicles can now use it. (In 2003, this rate was restricted to one vehicle.) Many companies, however, may reap more savings by skipping the standard rate and deducting annual expenses plus depreciation if they buy new vehicles and drive them more than half the time for business purposes.

Diversity still a drag in many 401(k) plans. A recent survey by benefits consultants Hewitt Associates reveals that many Americans haven’t taken Enron’s lessons to heart. It found that, on average, participants invested in only 3.6 of the 13 investment choices offered by defined-contribution plans in 2002. And, for those who held it, company stock made up an average of 42% of balances. Remember, diversification is among the most basic defensive measures you can take against economic and market uncertainties.



Taking a second look at 529 plans

Eric and his wife, Pam, recently celebrated the birth of their first child, Timmy. Ever since, one particularly persistent uncle can let neither phone call nor family gathering pass without haranguing the proud parents about “the miracle of 529 plans” for funding Timmy’s future college education. They listen politely but refuse to make any promises until they consult their financial advisor.

Eric and Pam’s advisor explains that these state-sponsored plans enable parents or grandparents to either secure tuition rates with a prepaid tuition program or create a tax-free savings account to fund college expenses. Distributions used to pay qualified higher education expenses are income-tax-free.

For investors, the benefits of 529 plans are well-documented: You can grow your savings tax free. Plus, your contributions may qualify for the \$11,000 annual gift tax exclusion (\$22,000 for joint gifts by married couples). In fact, you can elect to currently use annual exclusions for up to five years and make a \$55,000 contribution or a \$110,000 joint gift for each child.

Because of these and other advantages, 529 plans’ popularity has exploded. These accounts now hold more than \$20 billion and may hit the \$145 billion mark by 2008, according to research firm Cerulli Associates. That’s a far cry from 1999, when they were just beginning and not even half of the states in the country offered them.

3 red flags to watch for

So jumping on this bandwagon is a no-brainer, right? Not necessarily — three red flags have recently sprung up to throw it off course:

1. Tax law changes. As noted, among 529 plans’ most widely touted features has been tax-free growth. But last year’s tax law markedly lowered the long-term capital gains rate and created a new low rate for dividends. In doing so, other investment options — such as custodial accounts — suddenly had less of a tax disadvantage and became a more viable option because of their greater flexibility. Plus, unless Congress grants an extension,



529 plans will no longer be tax-free in 2011. On the other hand, the lower capital gains and dividends rates apply only through 2007.

2. Hefty fees. In many cases, high fees negate 529 plans’ tax advantages. You may encounter expense ratios on an account’s mutual funds, program management surcharges to cover administrative costs, and enrollment and account-maintenance fees. Added up, such costs can be devastating — especially when market performance hasn’t been good enough to offset them. Because you can use a plan from any state, choose carefully after looking at fees and investment performance.

3. State shutdowns. A third danger is that a 529 plan in your state won’t exist when you’re ready to enroll. Late last year, several states — including Ohio, Texas and Colorado — suspended prepaid-tuition-plan enrollment, citing that tuition was rising faster than investment earnings. Plan owners had the option of either leaving their funds in the accounts or moving them to some offered alternatives. In any case, state shutdowns have undermined investor confidence in these accounts.

One choice among many

Potential negatives, however, don’t mean that Eric and Pam — or you — should rule out a 529 plan. Rather, they simply mean these accounts are one choice among many when it comes to education funding. Look into all your options before committing any money. □



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