

Trendlines

New Directions in Business and Personal Planning



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529 savings plans remain viable education vehicles (for now)

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*Many students get a failing grade in tax planning,
Software license violations threaten companies...*

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Serving up a better health care plan

FSA's offer employers and employees plenty to chew on

Today's high health care costs have left workers and companies alike hungry for a better way to cover the former's medical needs without hurting the latter's profitability. One increasingly popular option that gives both parties plenty to chew on is the Flexible Spending Account (FSA), which can also provide dependent care benefits.



Appetizing choices

FSAs are usually offered through cafeteria plans, which allow employees to choose between cash and a menu of tax-free benefits. At the beginning of each plan year, workers estimate their expenses for the year and decide how much to contribute.

Contributions are funded with pretax dollars through salary reductions over the year. Employees pay qualifying out-of-pocket expenses as they're incurred and then submit reimbursement claims to the FSA plan administrator.

Workers may use FSA funds to pay a variety of out-of-pocket expenses not covered by insurance. Examples include annual deductibles, copays, orthodontia,

prescriptions and over-the-counter medications. FSAs for dependent care expenses work similarly.

For employers, FSAs not only provide a valuable benefit that current and prospective employees appreciate, but also reduce payroll by the amount of FSA contributions, avoiding FICA taxes and other payroll expenses on those amounts.

Generous portions

By leveraging pretax contributions, an FSA allows employees to enjoy significant savings on their out-of-pocket medical and dependent care expenses. For example, an employee in the 25% tax bracket who contributes \$4,000 annually can save \$1,000 per year.

Employees may contribute only up to \$5,000 per year to a dependent care FSA, but there's no legal limit on contributions to health care FSAs. Nevertheless, most employers set a cap on them to limit their financial risk.

Workers may use FSA funds to pay a variety of out-of-pocket expenses not covered by insurance.

That's because the plan must reimburse employees for qualifying medical expenses even if they're incurred before sufficient funds have been withheld from their salaries (provided the expenses don't exceed an employee's annual contribution amount). If an employee leaves the company before his or her FSA contributions "catch up" to previous reimbursements, the employer may be left holding the bag.

For instance, Jeff, an employee of ABC Inc., elects to contribute \$4,800 in 2006 to ABC's FSA. ABC deducts \$400 per month from Jeff's salary and contributes it to the account. On April 1, Jeff incurs \$4,000 in qualifying medical expenses and submits a claim. The plan reimburses Jeff for the full \$4,000, even though he's contributed only \$1,200 so far.

On July 1, Jeff's employment with ABC terminates. When he leaves the company, his FSA contributions for the year total \$2,400. ABC may not be able to collect the \$1,600 shortfall.

Eyes vs. stomach

FSAs hold dangers for employees as well. The accounts are subject to a strict "use it or lose it" rule stipulating that those who overestimate their expenses must forfeit any account balance remaining at year end. And once employees choose their contributions for the year, they can't change their elections except in the case of certain life-changing events, such as marriage, divorce, death or the birth of a child.

Fortunately, in 2005, the IRS offered some relief from the "use it or lose it" rule. Employers may now provide participants with a grace period of up to 2½ months after the end of the plan year. Workers can use remaining FSA funds to reimburse themselves for eligible expenses incurred during the grace period.

Bear in mind, though, that the grace period is available only if the employer amends its plan to allow it. And, unless the plan is further amended, extended coverage will be considered "other coverage" that would disqualify employees from contributing to a Health Savings Account (HSA). For a brief summary of these arrangements, see "HSAs: Similar, but not the same" at right.

Check, please

Companies considering an FSA should compare the benefits and costs to those associated with other options. The tab for setting one up includes legal, administrative and ongoing compliance costs. In addition, employers

HSAs: Similar, but not the same

Like Flexible Spending Accounts (FSAs), Health Savings Accounts (HSAs) allow participants to pay qualifying medical expenses with pretax dollars. But unlike FSAs, HSAs have no "use it or lose it" feature — amounts remaining at year end roll over tax free.

For employees with modest health care expenses, an HSA can also serve as a supplemental retirement plan, as unused funds continue to grow tax free and can be withdrawn for any purpose without penalty, though subject to income tax, after age 65. (Early withdrawals are subject to a 10% penalty.)

What's the catch? Employers must offer an HSA in conjunction with a high-deductible health plan (HDHP). For 2006, that means a plan with an annual deductible of at least \$1,050 for individual coverage and \$2,100 for family coverage, plus an annual out-of-pocket limit of no more than \$5,250 for individual coverage and \$10,500 for family coverage.

To qualify, an employee must be covered by an HDHP and generally must not be covered by any non-HDHP health insurance. The maximum contribution for 2006 is the lesser of the HDHP's annual deductible or \$2,700 for individuals and \$5,450 for families. Additional "catch-up" contributions are allowed for those 55 and older.

HSAs can reduce the employer's costs in two ways. First, switching to an HDHP usually reduces employer premiums. Second, the ability to tap unused contributions for other purposes provides employees with a powerful incentive to manage their health care costs, which, in turn, may lessen future health insurance expenses for the company.

must pass nondiscrimination tests that prevent them from favoring key employees.

That said, these accounts are growing in popularity. After incurring the initial costs, many businesses are saving money by passing on rising health care costs to their workers. And those employees don't mind as much because FSAs grant them a cost-effective way to cover, track and ultimately lower their medical expenses. ■



A winning formula

Buy-sell agreements and life insurance bring peace of mind

As a business owner, your tendency may be to focus on today's headaches. But you still need to think about tomorrow's. For instance, what would happen to your company if you weren't around to run it?

Retirement may be years away. But disability and premature death can set into motion adverse events for your company and family — unless you've considered your options much earlier.

That's why a sound buy-sell agreement, typically funded by life insurance, is a winning formula for preserving your business and your family's financial future.

What's the point?

The main purpose of a buy-sell agreement is to keep your business running after your (or another owner's) departure. It enables the execution of a smooth transition in the control and ownership of the entity, allowing your company to remain in good standing with clients, creditors and employees — therefore preserving the value of the business.

A buy-sell agreement also establishes a ready market for your shares. This ensures that, when you eventually do

(or must) sell, there will be a fair price, clearly defined terms and available funding.

Of course, creating a buy-sell agreement forces you to ask some tough questions, including:

- ☞ What events should trigger a sale?
- ☞ Who should purchase the shares — the company, other shareholders or both?
- ☞ How much will be paid?
- ☞ How will purchases be funded?

Death, retirement, withdrawal from employment, disability, divorce or a contemplated sale to a third party are all valid triggering events to initiate the buy-sell process.

Once a triggering event occurs, you also must decide whether the sale should be:

- ☞ Mandatory,
- ☞ Optional to the shareholder, or
- ☞ Optional to the company.

Death is usually one of the key triggers. It's generally mandatory that someone buy the deceased's shares to generate liquidity for the deceased's family. Similarly, if a shareholder-employee is no longer able to work, a buyout would generate funds to support him or her.

Why life insurance?

As mentioned, funding a buy-sell agreement with life insurance is often the best way to go. There are a number of reasons why, including:

It's basically a sure thing. Life insurance is the only funding option that virtually guarantees the immediate



availability of the full buyout amount at your death, assuming sufficient coverage and a history of timely premium payments.

You'll secure a tax break. Under current tax law, death benefits aren't subject to income tax. Thus, the full proceeds will be available for the buyout. An added perk: If a premature death occurs, the total premiums paid on a life insurance policy are normally a fraction of the cash received as a death benefit.

If yours is a policy that accumulates cash value, this amount is also figured on a tax-advantaged basis. The cash value may help fund a retirement or other buyout during your lifetime. Keep in mind, though, that your health and age play a large part in obtaining life insurance.

Your shares' value will be established. A buy-sell agreement to cover the value of each owner's shares eliminates the need to negotiate a value every year. The agreement provides an independent mechanism for determining a price or pricing formula for the business interest, lessening the potential for disputes.

A buy-sell agreement relieves loved ones from having to make business decisions.

The agreement and any insurance policies should, however, be reviewed periodically as the business grows and as it undergoes changes in structure or ownership.

You can keep out unwanted shareholders. Establishing a buy-sell agreement and funding it with life insurance prevents unwanted parties from acquiring an ownership interest. Proper planning will help preclude family members or third-party competitors from acquiring or claiming a stake in your company's daily decision making.



If life insurance isn't used to fund the buyout, the buy-sell agreement needs to state how and when the payment will be made to avoid possible misunderstandings or legal actions. And, of course, life insurance isn't as helpful in funding purchases of your shares during your life.

Other options for funding a buy-sell agreement include paying out the purchase over a period of years, borrowing the necessary funds or using specific business assets, such as a parcel of real estate.

Are there any other reasons?

If you're still reluctant to create a buy-sell agreement because it's unpleasant to contemplate death, disability or other events that might dictate an ownership change, at least think about your loved ones. The agreement, after all, helps set the value of the interest for federal estate tax purposes. And this "arm's-length" negotiated value helps reduce the possibility of an IRS challenge.

In the meantime, the agreement expedites your estate's disposition. Because you've negotiated the sale terms during your lifetime, family members are generally assured a timely cash disbursement. And it can alleviate any disputes between your heirs and the surviving business owners.

Furthermore, a buy-sell agreement relieves loved ones from having to make business decisions. A relative who never worked for your company probably won't want to assume the ongoing worries of future operations. Your agreement's terms can stipulate that disinterested heirs must be bought out and protected from such responsibility.

Finally, the agreement avoids negotiating price and terms when the estate may be in a weak bargaining

position. The lack of a buy-sell agreement before an owner's death alters the playing field. In worst cases, when an estate is facing administrative and tax costs and has few liquid assets, a "fire sale" may occur — something you'd probably never wish on your family.

Will this hurt?

The process of drafting a buy-sell agreement isn't painless. It involves time and energy, and it may force you to ponder circumstances you'd rather not think about.

But as long as you procure the help of your CPA, attorney and perhaps other trusted advisors, you'll get through it just fine — thousands of other business owners already have. ■



Moneylines: News briefs for businesses and individuals

Many students get a failing grade in tax planning. If you have a child, grandchild, niece or nephew in college, you may want to tell him or her to hit the books — the tax books. After studying 1.8 million tax returns, the Government Accountability Office found that about one in four taxpayers who could have taken an education-related tax break (be it credit or deduction) failed to do so. These uninformed filers missed out on an average \$169 in tax savings.

Software license violations threaten companies. Most business owners know that violating their software licensing agreements can be quite costly. Yet a recent study by the Software and Information Industry Association, the Centralized Electronic Licensing User Group and Macrovision indicated that 72% of responding companies tracked license compliance manually or not at all. If your company falls into that group, you're at high risk for violations that could cost you thousands in fines and bad publicity.

Identity theft insurance gets mixed reviews. A person victimized by identity theft spends, on average, \$6,100 and 86 hours to resolve the problem, says the Institute of Consumer Financial Education. In response, many insurers are offering identity theft policies that, rather than cover the victim's financial losses, protect against recovery expenses, such as telephone costs, mailing expenses and lost work time. But it's debatable whether the coverage is worth the cost. Some say the policies just add to identity theft's expense, while others purport that the insurance can be a critical backup during a difficult time.

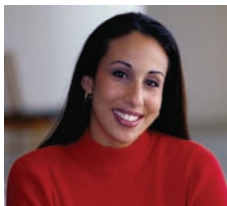
Electronic payments can cure woes of meeting estimated tax deadlines. If you're an independent contractor or self-employed, you're no doubt aware that you must make quarterly estimated tax payments. You may also be aware of how easy it is to procrastinate on making these payments and how slowly the money reaches the Federal government via snail mail. Well, now there's a better way: You can avoid the hassle — and the potential late fines — by signing up to make electronic payments at www.EFTPS.gov. Just be sure to do so at least 15 days before making your first payment.



529 savings plans remain viable education vehicles (for now)

Julia was the first member of her family to earn a college degree. The experience was so formative that she vowed to do everything in her power to ensure *her* children could get a degree, too. Well, a couple of years ago, Julia gave birth to Connor, a bouncing baby boy. To begin making good on her promise, she visited her financial advisor.

He explained that she had many options for funding Connor's college experience, including Coverdell Education Savings Accounts, EE savings bonds, Uniform Gifts to Minors Act accounts and 529 prepaid tuition plans.



But, given her age and financial situation, he recommended she first consider the popular and well-publicized 529 *savings* plan. These state-sponsored arrangements combine tax advantages, flexibility and control. But they're not without their drawbacks.

Exceptional benefits

529 savings plans have grown in availability and popularity for a reason, Julia's advisor explains. One would provide a remarkable variety of benefits for her and Connor, including:

Tax-free withdrawals. Contributions aren't deductible, but earnings and withdrawals are tax free if they're used to pay for qualified higher education expenses, such as tuition, fees, books, supplies and equipment, and certain room and board costs. Nonqualified withdrawals are subject to income tax and a 10% penalty.

Limited limitations. Julia's lucrative advertising business wouldn't be a problem because anyone can contribute to a plan, regardless of income level. The benefits of many other education tax breaks are phased out for higher income taxpayers. Most states permit contributions of between \$200,000 and \$300,000 on behalf of a single beneficiary.

Financial aid advantages. Julia, not Connor, would own the plan assets. Thus, they'd minimally affect his financial aid eligibility.

Beneficiary flexibility. Julia could change beneficiaries to another family member (including cousins) at any time, transfer the funds into another state's plan (as often as once a year) and even take back the money (subject to taxes and penalties).

Estate planning benefits. Plan funds would be removed from her taxable estate, even though she'd retain control over them. Her contributions are eligible for the \$12,000 annual gift tax exclusion or \$24,000 if she splits the gift with her husband. Plus, she could accelerate five years of annual exclusions and make an up-front, tax free contribution of up to \$60,000 herself or \$120,000 with her husband.

An uncertain future

The main disadvantage of 529 savings plans is uncertainty. Some benefits — including tax-free withdrawals — were created by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). And, like many of the law's provisions, they will "sunset" at the end of 2010.

Congress is considering several bills that would make some or all of EGTRRA's changes permanent. But if these bills aren't passed, 529 savings plan withdrawals after 2010 will no longer be tax free. Instead, they will be taxed at the beneficiary's tax rate — still a big advantage for most families.

Also, plan owners will no longer be able to roll the funds into another state's plan without changing beneficiaries, and cousins will no longer be considered "family members."

Many possibilities

Julia's advisor, along with many observers, believe that Congress will make the benefits of 529 savings plans permanent. Nevertheless, he urges her to take into account the possibility that some plan features may expire and significantly lessen the plan's appeal. And, as the advisor initially mentioned, there are other college funding options to consider. ■



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