December 2001

tax and accounting issues

The Changing Structure of the Workforce

2001 Year End Tax Planning

The following items have special significance this year because of economic conditions and legislative events during 2001.

1) Employers should review employee benefit plans and compensation arrangements for 2002.

The 2001 tax act featured the most sweeping changes to retirement savings programs in recent memory. These include expansion of 401(k) and IRA contribution opportunities. For a complete discussion of these changes, see our October 2001 newsletter. This is important stuff and merits the attention of all taxpayers.

The changes with the most dramatic impact are the repeal of percentage of income limitations on elective employee salary deferrals, and new decoupling of employer and employee contributions. Previously, these contributions were aggregated in the calculation of contribution limitations. These changes may particularly benefit working spouses and self-employed individuals (who qualify as employees for the purpose of making elective deferrals).

Maintaining qualified retirement plans requires meeting the requirements of a complex set of non-discrimination rules. The main benefit of having qualified plan status is that contributions are deductible when paid into the plan, but are not taxable to the beneficiary until distributions are made. With proper planning, these tax deferrals can be engineered to continue even after the death of the employee who earned the benefits.

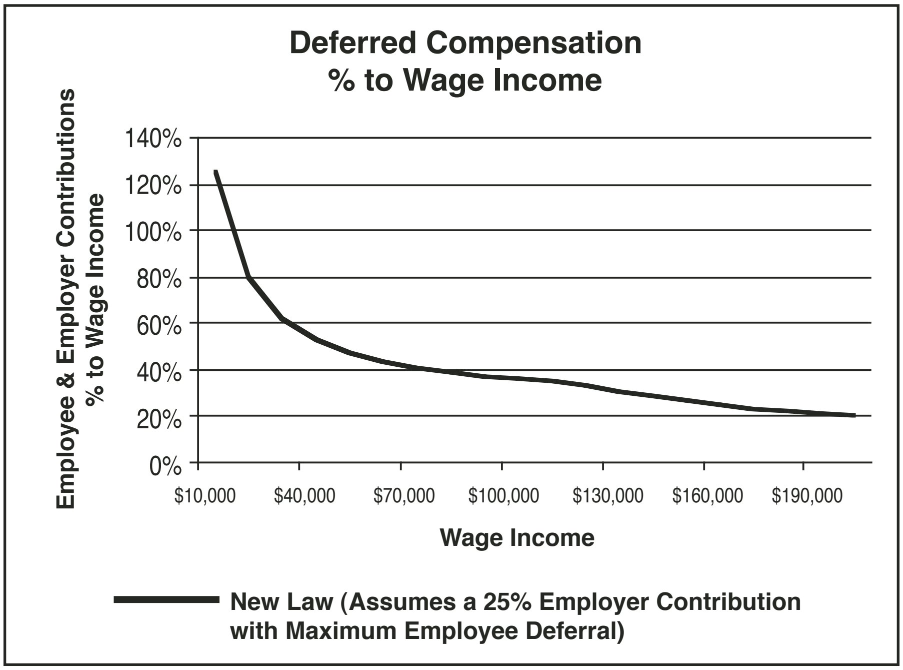
Historically, most employers have treated benefit contributions as an afterthought in their overall compensation arrangements with employees. These employers seem content to have employees create their own retirement benefit via 401(k) plan salary deferrals, and only kick in small matching contributions to encourage lower compensated employees to participate in the plan. Employees have generally regarded employer pension contributions as not being the equivalent of cash wages.

The new expanded pension benefits made available in the 2001 tax act may change all this. Employees will be allowed to make elective wage deferrals equal to 100% of wages, up to $11,000 for 2002. The chart on the following page is not incorrect when it shows deferred compensation equal to 125% of wages for someone making $10,000. This would occur when the individual defers 100% of their wages and receives a 25% employer pension contribution. The maximum percentage declines as income increases because once the maximum elective deferral is reached, any incremental deferred compensation comes only from employer contributions. These are capped at 25% of wages.

If one considers the possibility of providing medical coverage in addition to these pension benefits, it is conceivable that this could lead to situations where employees are working for little in the way of cash wages.

Peter M. Rub, CPA

33 N. Dearborn St./Suite 504 • Chicago, Illinois 60602
312/372-2268 • FAX: 312/372-6179 • *Pete.Rub@RubCPA.com*



There are groups of potential employees that could find this highly attractive, such as the spouses of working professionals, or professionals who continue to work on a part time basis after changing careers late in life. The common thread between the two is that neither needs to cash compensation to meet current living expenses. These employees could find it very attractive to work for companies where the compensation structure results in a low income tax burden.

From the company perspective, the benefits structure is inextricably tied into hiring strategies. If you are trying to give highly compensated key employees the maximum tax sheltering opportunities, then hiring part time employees who have the same objectives is a big plus in meeting participation and non-discrimination standards. Who do you want to hire, the employee who is living hand to mouth and can't afford to participate in retirement plans, or the older employee who may decide that tax avoidance is critical factor in deciding between employment opportunities?

We have gone through a period where large companies have let loose large numbers of older employees. This has been done because these people have higher cash wages and associated pension costs. This is especially true in companies that maintain defined benefit plans. Most of the company contributions to these plans occur in the years just before retirement age. By having a younger work force, large companies got the double benefit of lower cash wages and lower pension expense.

The 2001 tax act turns this situation on its head, with the primary beneficiaries being small employers that have the flexibility to creatively structure compensation arrangements. Small businesses are interested in keeping employee turnover low because of the hiring and training costs associated with "up or out" employment. In recent years, hiring older workers with proven work experience and skills has become a workable alternative to dealing with a young workforce that is continually turning over. Small businesses don't maintain defined benefit plans that make hiring older workers unattractive.

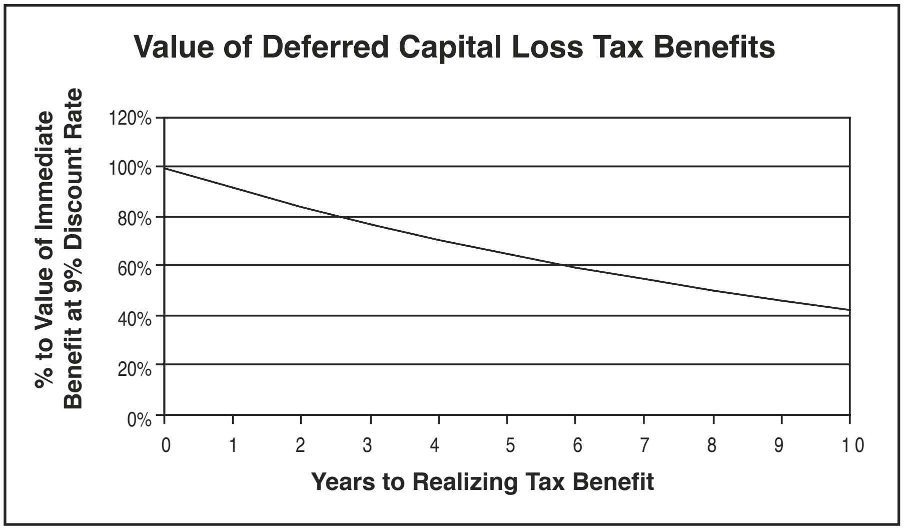
The problem that large business face is that they are hooked on the old employment model and are too large and inflexible to become attractive to these new groups of experienced and available workers. How can a large business have a compensation structure oriented towards non-taxable fringe benefits if it depends of keeping costs down by having a younger workforce that is no position to defer income into retirement savings? One alternative is outsourcing, but this has its own set of management and payroll tax problems (like having your "independent contractors" characterized by the IRS as being employees).

Small businesses, in stark contrast, have the ability to be more selective in their hiring, and can be more flexible in setting up and selling compensation arrangements to employees and potential new hires. This is one of the key advantages of staying small and focused in the management of your business. The interaction between pension law and the compensation policies of businesses is a graphic example of why tax strategies don't work in a vacuum.

Action: *Business owners should consider the 2001 changes to pension law when structuring compensation arrangement and hiring policies.*

Serious thought should be given to terminating Money Purchase pension plans in favor of Profit Sharing plans that provide for elective employee deferrals.

Amendments to pension plans for the 2002 should be adopted to conform to changes from the 2001 tax act.



2) Review unrealized gains and losses in your investment portfolio.

With the recent volatility in the securities markets, investors must pay special attention to getting tax benefits from capital losses. Capital losses in excess of capital gains are only deductible against other sources of income up to $3,000 per year. Any excess losses are carried forward to future tax years. If the tax benefit from deducting a capital loss cannot immediately realized, its value decreases depending on an individual's opportunity cost of money. This produces declines in value as shown in the following chart.

If capital losses have been realized that exceed the $3,000 limit, taxpayers have the choice of either realizing capital gains to offset the losses or carrying forward the losses. A taxpayer's choice, of course, depends on the availability of unrealized capital gains and whether the losses are so large as to create a permanent impairment in the value of the tax benefit if carried forward to more than a year or two.

Action: *If you invested in some lemons, make lemonade by getting an immediate tax benefit from your capital losses. If you have capital losses in excess if the $3,000 per year limit, realize gains to eliminate the capital loss carryforward.*

If you have realized capital gains and have unrealized capital losses, take the capital losses to the extent of capital gains that will be taxed at a 20% or higher rate.

3) Employees should review benefit elections before year-end.

Because of the sweeping effect of the pension law changes enacted in 2001, it is unlikely that the full benefit of these changes will be reflected in changes to retirement plans until 2003, especially if changes to the compensation structures of companies will be an integral part of the change. However, there are some changes that require immediate attention. For 2002 there will be no percentage of income limitation on elective wage deferrals, and employee contributions can be boosted significantly.

Action: *Review 401(k) wage deferral opportunities.*

Determine what happens if elected deferrals exceed the amount that is deductible. (Is the excess contribution refunded or kept in the plan as an after tax contribution?) Determine the contribution that is expected to be tax deductible.

4) Do cash flow planning for 2002 to accommodate new savings options.

We seem to be in a period when the ability of individuals to generate tax deductions is more limited by cash flow considerations than by limitations under the Internal Revenue Code. Individuals with the ability to fund these tax-deductible contributions will benefit greatly. Those who can't will pay the nation's income taxes.

> **Action:** *Prepare cash flow calculations for 2002 if you are uncertain as to whether you will be able to fund deductible contributions. You can then make informed choices to either reduce consumption expenditures or incur debt to finance the retirement savings contributions.*

(Our tax projection models feature calculations of cash flow after taxes, living expenses, and investments. These have been updated to reflect these new retirement savings options, and provide a quick assessment of the adequacy of your cash flow.)

5) Loans from qualified retirement plans can now be made to sole proprietors, partners, and S corporation shareholders.

Previously, loans from qualified retirement plans and IRA were considered to be prohibited transactions subject to a 15% excise tax. The only way an owner could access money in these plans was by taking a taxable distribution. This discouraged business owners from adopting qualified retirement plans because the money was essentially locked up in the plan until retirement age was attained.

The 2001 tax act allows the business owners noted above to borrow money from qualified retirement plans on the same basis as other employees. The maximum available loan is the lesser of $50,000 or 1⁄2 of the participant's vested benefits. If the loan proceeds are not used to purchase a principal residence, the loan must repaid over a 5-year period with level amortization of the loan balance, and payments must be made at least quarterly. (This change does not apply to IRA's or SEP's, and is effective starting in 2002.)

> **Action:** *Business owners should consider amending plan documents to allow for participant loans.*

Business owners who might need access to funds before retirement should consider using Profit Sharing plans instead of SEP's.

6) Taxpayers who are required to make IRA distributions need to decide whether to use the new rules for 2001.

The IRS issued a new set of distribution rules during 2001, and taxpayers have the option this year of using these rules for determining minimum required distributions or using the old rules that had been in effect since 1987. Generally, a smaller distribution is allowed under the new rules if the designated beneficiary of the IRA owner was above age 60 at the time distributions commenced.

> **Action:** *Taxpayers who are required to make required IRA distributions should prepare distribution schedules reflecting the new regulations.*

Before the 2001 distribution is made, the minimum distribution under the new rules should be compared to what was required under the old 1987 regulations.