

Preferential Tax Rates for Qualified Dividends Create Planning Opportunities and Confusion

As reported in the July/August 2003 issue of the Holtz Rubenstein *Adviser*, the Jobs and Growth Tax Relief Reconciliation Act of 2003 provides preferential tax treatment of certain dividend income. The Act provides a maximum rate of 15% on qualified dividends received beginning on January 1, 2003. The dividend provisions are scheduled to expire effective January 1, 2009.

The scope of the dividend tax relief is limited to dividends that are “qualified dividends.” Dividends from foreign corporations are qualified only if the stock of the corporation is readily tradable on an established securities market in the United States, if the corporation was incorporated in a possession of the United States, or if the corporation is eligible for benefits under a tax treaty.

Certain amounts commonly referred to as “dividends” are not dividends under the tax law. Money market “dividends,” credit union “dividends” paid on savings accounts, “dividends” paid by insurance companies to policy holders and distributions received on certain preferred stock do not constitute qualified dividends.

A dividend is not a qualified dividend if the taxpayer does not hold the stock for at least 61 days in the 121-day period beginning 60 days before the ex-dividend date.

This (61/121/60 day) rule is intended to prevent the taxpayer from purchasing a stock shortly before the ex-dividend date and selling it immediately afterward, recognizing dividend income that would be offset by a short term capital loss. In determining the taxpayer’s holding period, the day of disposition is taken into account but the day of acquisition is not.

***Example:** On May 28, 2003 Altria Group Inc. declared a 64-cent per share dividend payable on July 8 to shareholders of record on June 13. The ex-dividend date was June 11, two trading days before the record date. Under the three-day settlement rule used by United States securities exchanges, trades executed on June 11 settled on Monday, June 16, the third subsequent trading day. Therefore, purchasers on June 11 would not receive the July 8 dividend.*

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Notable and Quotable

Congratulations to Audit Manager **Harold Deiters** for being named among the *Long Island Business News* “40 Under 40” Class of 2004! The “40 Under 40” is the annual salute to 40 up and comers under the age of 40 who will be shaping and directing the future of Long Island. *Long Island Business News* describes the honorees as “...a group of hard-charging, talented and dedicated young professionals who are already making a significant mark in business and in their communities.”

Are you taking advantage of all the deductions your house has to offer you? Long Islanders got some advice from a recent *Newsday* article, in which Partner **Alan Weiner** was featured prominently (along with a big picture, no less). Alan also was recently featured in some other high-profile articles, in publications including *The New York Times* business section (in an article on NY State taxes due on out-of-state shopping) and he is a frequent contributor to *Newsday*’s “Family Finance” Sunday columns.

The firm began 2004 with an expansion in several departments, including emerging business, not-for-profit, and tax:

Brian K. Cleary, CPA is the newest Senior Manager in the emerging business department. In his 11 years in public accounting he has had extensive experience in providing accounting, auditing, tax, and business advisory services for

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The relevant 121-day period runs from April 12 (60 days before the June 11 ex-dividend date) through August 10. A stockholder must hold the stock for at least 61 days during that period for the July 8 dividend to be a qualified dividend as to that taxpayer.

Therefore, a taxpayer who bought Altria on June 10 (the latest date to buy the shares and gain entitlement to the dividend) and sold it on or after August 11 would have dividend income constituting qualified dividend income. The holding period would encompass 20 days in June (not counting the June 10 date of acquisition), 31 days in July and 10 days in August, for a total of 61 days. Also, a taxpayer who owned Altria prior to April 12 and sold on June 11, the ex-dividend date, would be entitled to treat the July 8 dividend as a qualified dividend. The holding period, or purposes of the 61-day test, would encompass 19 days in April, 31 days in May, and 11 days in June, including the date of disposition, for a total of 61 days.

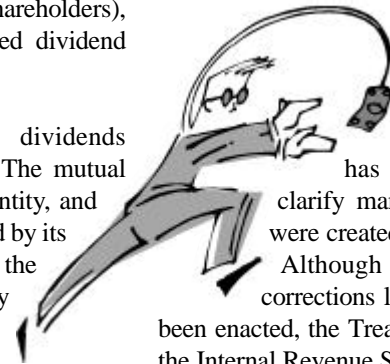
The 61/60/121 day rule is an ongoing requirement for all years, not just 2003.

Dividends received by shareholders of real estate investment trusts, or REITs, generally will be taxed as ordinary income. However, to the extent that the dividend from the REIT represents qualified dividends that the REIT received, or represents a distribution of income that the REIT paid tax on (a REIT is generally exempt from tax at the entity level, but pays tax on the excess of its taxable income over the dividends distributed to its shareholders), the dividend will be a qualified dividend subject to tax at 15 percent.

Special rules apply to dividends received from mutual funds. The mutual fund is treated as a pass-thru entity, and the character of income received by its shareholders is the same as the character of income received by the mutual fund. To the extent that a dividend reported by a mutual fund represents a pass-thru of qualified dividends received by the fund on its underlying investments in stock (including the requirement that the mutual

fund satisfies the 61 day holding period requirement), the dividend is a qualified dividend eligible for the 15 percent tax rate. However, to the extent that the dividend represents a pass-thru of interest income earned by the mutual fund on bonds, commercial paper or other short-term investments, the dividend will be taxed as ordinary income to the mutual fund shareholders.

Many brokerage firms have indicated that they will issue amended 1099s because of the complexity in interpreting and applying the provisions of the new law. Legislation has been proposed to clarify many of the issues that were created under the 2003 law. Although this technical corrections legislation has not yet been enacted, the Treasury Department and the Internal Revenue Service have agreed to let taxpayers apply the provisions of this law relating to qualified dividends as if the legislation were already enacted. This retroactive application of the law is intended to eliminate the need of requiring amended dividend statements and tax returns.



CyberNotes


Weather Underground

WUnderground.com is a must-visit site for weather freaks. Not only does it include the regular features like current conditions and weather maps, but it also provides an impressively complete weather picture in your town. Enter your zip code and get radar images, allergy information, ski conditions, and even satellite images that offer you a snapshot of your hometown from space. And for a very nominal membership fee, **WUnderground.com** will e-mail you weather updates immediately as they are issued by the National Weather Service.

Acronymfinder.com

Check out the WWW ASAP! You probably know the previous sentence is advising you to go to the World Wide Web as soon as possible. Those are common acronyms (a pronounceable word formed from each of the first letters of a descriptive phrase).

But if you need to know the difference between NATO and USO, visit **Acronymfinder.com**. You'll quickly find that these are acronyms for "North Atlantic Treaty Organization," and "United Service Organization." On an average day, 195 new acronyms are submitted by users each day.

Did you know that "acronym" is itself an acronym? According to **Acronymfinder.com**, it could mean anything from "A Concise Recollection of Nomenclature Yielding Mnemonics" to "A Crazy Reminder Of Names You Misplaced." 

Planning opportunities for individuals

To prevent a taxpayer from obtaining the benefit of income taxed at 15 percent coupled with a deduction producing a 35 percent tax benefit, the law provides that any amounts treated as investment income will not be treated as qualified dividends. Investment income is significant because a taxpayer's deduction for investment interest expense is limited to his investment income. The following example illustrates this rule and the options available to the taxpayer.

Example: Taxpayer buys \$200,000 of stock in a margin account, investing \$100,000 of his own money and using a margin loan of \$100,000 to fund the balance of the purchase. Interest on the margin loan is \$4,000 and the stocks yield dividend income of \$4,000. The taxpayer has no other items of investment income (i.e., interest, dividends or short-term capital gains) or investment interest expense.

If the taxpayer does not take the dividends into account as investment income,

they will be qualified dividends subject to the 15 percent tax rate. However, the taxpayer then will have no investment income, and the \$4,000 of investment interest expense will be disallowed in the current year and carried forward. Therefore, the taxpayer will incur a current Federal tax liability of \$600 (\$4,000 at 15 percent) on his investment activity. If the taxpayer receives sufficient investment income in the next year (e.g., through short-term capital gains) to use the investment interest expense, it will produce a Federal tax benefit of up to \$1,400 (\$4,000 at 35 percent, assuming that the taxpayer is in the highest tax bracket).

In the alternative, the taxpayer can elect to treat the dividends as investment income, and deduct the investment interest expense in the current year. Therefore, there will be no tax attributable to the current investment activity. However, the taxpayer sacrifices the opportunity to receive a future tax benefit at the 35 percent rate on his investment interest expense. The taxpayer's decision would be based upon his expectation of recognizing sufficient investment income in a future year to obtain the benefit of the 35 percent deduction for the investment interest expense. Taxpayers will have the benefit of up to nine and one-half months of hindsight (i.e., the ability to look at year to date investment income through the extended due date of their returns, October 15 of the following year) before making this decision.

If the taxpayer in the above example had used a home equity loan rather than a margin loan to fund the purchase of the securities, the interest expense would be deductible for regular tax purposes as qualified residence interest. Therefore, the taxpayer would pay \$600 of tax on his dividend income (\$4,000 at 15%) and get a tax benefit of \$1,400 on the home equity interest (\$4,000 at 35%). However, because the proceeds of the home equity loan were not used to acquire, construct or substantially improve the principal residence, the interest expense would not be deductible for purposes of the alternative minimum tax.

The favorable tax treatment for qualified dividend income calls for taxpayers to reconsider their investment and retirement strategies. Income from annuities and distributions from retirement plans (including IRAs) are taxable as ordinary

income. Therefore, use of these vehicles, while allowing for a deferral of income, could convert income that would otherwise have been taxable at 15% into income taxable at 35%. (Of course, these amounts assume that the rates presently in effect remain unchanged at the time the individual receives taxable annuity payments or retirement account distributions.)

Taxpayers who have been purchasing annuities or making contributions to retirement plans should consider investing in taxable accounts in view of the lower tax rates applicable to investment income. Although paying an annual 15% tax on the dividend income will reduce the benefits of tax-free compound growth that a retirement plan or an IRA offers, all plan distributions will ultimately be taxed as ordinary income.

In the alternative, taxpayers who invest through both taxable and tax-deferred accounts should consider using their taxable accounts to hold their stocks and their tax-deferred accounts to hold their bonds.

Before making such a change, however, taxpayers should recognize that under present law, the JGTRRA benefits are scheduled to expire after 2008. Although many people believe that Congress will extend these benefits, there is no assurance that such an extension will be enacted. Therefore, taxpayers could find themselves paying current tax at rates approaching 40% (including state tax) on income that otherwise could have been deferred.

In deciding whether or not to forego their current retirement plan contributions, taxpayers must consider the amount of time that they have until they would begin taking distributions and their outlook on how future legislation will effect the tax treatment of their investment gains.

Planning opportunities for corporations

The law presents planning opportunities for closely held corporations. C corporations with no current tax liability (due to net operating losses or nonrefundable tax credits, for example) might consider making dividend

payments to shareholders in lieu of salary payments to allow the shareholders to obtain the benefit of the favorable tax rate. This approach also saves payroll taxes that are imposed on salaries on both the shareholders and on the corporation.

Of course, the corporation must consider any bank covenants that might restrict dividend payments and must also consider the impact that the reduced salaries would have on an allowable deferred compensation plan contribution. In addition, the IRS has argued successfully in a number of cases that purported dividend distributions to shareholders actually represented compensation subject to payroll taxes. Corporations should be less susceptible to this attack from the IRS if one or more shareholders do not perform significant services for the corporation, and the distribution bears all the formal indicia of dividend payments (i.e., pro-rata among all shareholders and designated as dividends in the appropriate corporate records).

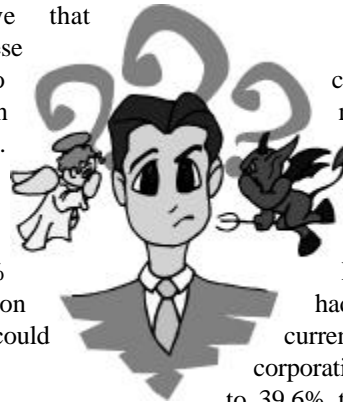
C corporations that face a potential accumulated earnings tax issue have the opportunity to eliminate that potential liability by making a distribution at a lower tax cost to its shareholders than in prior years.

S corporations that have C corporation earnings and profits might consider distributing those C corporation earnings given the reduced tax cost. Many former C corporations made S elections as a result of the Tax Reform Act of 1986 and have had money that was not needed for current operations "trapped" in the corporation since then by tax rates of up to 39.6% that would have applied to the shareholders. Although the higher tax rates dissuaded the corporation from distributing this money in prior years, the 15% rate could provide sufficient incentive to make the distribution.

Note Regarding State and Local Taxes

New York State and City (as well as other states') taxes always must be factored in to any tax planning.

For more information, please contact Senior Tax Manager Barry Nagler at 631-752-7400 x-354 or BNagler@hrcpa.com.



Keeping the Cash Flowing in an Expanding Economy

By Jerome Hehir

As we slowly turn the economic corner early in 2004, we are beginning to see signs of an improving economy in the United States, as well as in and around Long Island. All businesses need to anticipate economic trends and be prepared for slow downs as well as expanding economies. While slow downs pose their own challenges, companies may miss the boat in an expanding economy if they are not prepared for the cash flow challenges that accompany a surge in growth.



Jerome Hehir

It always is important to keep an eye on cash flow, as it is the life-blood of small business. As a business expands it will usually endure periods of extreme cash crunches. With increased inventory purchases and credit terms offered to customers, the timing of cash disbursements and cash receipts might be out of sync. In addition, in order to facilitate the additional business, more labor may be required or utilization of resources may increase at a rate that outpaces current cash availability.

For a small business to survive a growing business cycle it must be prepared for and expect periods of poor cash flow. Therefore, it is very important to maximize your cash flow opportunities:

Monitor accounts receivable daily. Every business needs to be aware of slow paying customers and maintain strong credit policies to avoid possible losses from bad debts. In addition, by being aware of customers who always pay on time, you can improve cash flow by offering them term discounts and volume discounts for early payment.

Analyze the sales flow from purchase order to delivery and ultimate collection, and determine if any of the steps in between can be shortened.

Customer deposits are common in many industries and all efforts should be made to collect the largest deposit possible up front when agreeing to sales terms with a customer. It may be possible to get a customer to make installment payments when there is a long lead time to delivery.

The timing of inventory. Inventory can be one of the most complex items a business has to manage in a growing economy. The timing and volume of inventory purchases can greatly affect cash flow as well as overall sales. Not buying enough can lead to lost sales. Overbuying can lead to a cash crunch and being overstocked. Therefore, careful buying and anticipation of customer orders will lead to more effective cash management.

Take advantage of terms from vendors. If it is not practical to take advantage of term discounts, payments of bills should be done at the latest possible date so as to keep unaffected your flow of goods and your credit.


Make the most of pricing terms from vendors as it directly affects the gross margin on sales of those products. However, cash flow does not always allow a business to take advantage of these opportunities. This may be time to consider a business line of credit from a bank. In these days of low interest rates, it may be beneficial to borrow the funds to take advantage of volume discounts or term pricing from a vendor. The savings offered by the vendor discounts may far outweigh the interest cost involved in borrowing.



Maintain a relationship with your banker. Certain industries may require significant capital expenditures to facilitate growth and expansion. Therefore, it is important to sustain a strong relationship with your banker and other lending institutions. Large capital expenditures should be made with appropriate financing terms. This could be in the form of an operating lease or a term loan, which calls for payments over an extended period of time that mirrors the expected useful life of the equipment or improvement.


EFTPS Express Enrollment for New Businesses

On January 12, 2004, the Internal Revenue Service launched a new program to allow new businesses a quicker way to access the Electronic Federal Tax Payment System (EFTPS). Businesses receiving a new Employer Identification Number (EIN) that have a federal tax obligation will be automatically pre-enrolled in the EFTPS to make all their Federal Tax Deposits.

When taxpayers receive their EIN, they also will receive a separate mailing containing an EFTPS Personal Identification Number (PIN) and instructions for activating their enrollment. New business taxpayers can activate their enrollment by calling a toll free number, entering their banking information, and completing an authorization. 

Good use of management tools, such as cash budgets and forecasting also will prove to be effective. This will allow your business to predict the buying trends of your customers, so you can better anticipate your inventory needs. In addition, it will allow your business to analyze “what if” situations, so as to not miss out on business opportunities that might only arise in periods of growth.

Take advantage of new tax laws. The IRS recently has increased deduction limits for new equipment acquisitions. By taking advantage of these accelerated depreciation rules, companies can defer taxable income to a later period when cash flow has improved. In addition, companies should consider the method of accounting being utilized for tax purposes. For instance, certain businesses qualify to calculate their taxable income on the cash basis. This concept, coupled with the new depreciation rules, can greatly reduce the tax liability for a company and its shareholders.

For more information on maximizing cash flow opportunities, contact Senior Audit Manager Jerome Hehir at 631-752-7400 x-202 or JHehir@hrcpa.com. 

Medicare Prescription Drug Discount Card

There has been an incredible amount of information in the news lately concerning the new Medicare Prescription Drug Discount Card Plan, which recently was passed by Congress and signed into law by President Bush. While interest in the new benefit is high, its introduction may be confusing to many Medicare recipients and their families.

The government-provided benefit does not begin until 2006. However, there will be government-approved drug discount cards available this spring.

Over 100 companies, including insurers, pharmacy chains, and pharmacy benefit managers have applied to be approved to offer the cards. Their motive is to be entrenched in the marketplace when the government-funded benefits begin. Each provider will be offering a unique package of discounts, which will vary from drug to drug. While all of the sponsors will not be offering plans in every geographic market, a major market like New York could have as many as 50 plans competing. Each Medicare recipient can only choose one, making it a potentially difficult and confusing choice.

If an individual only needs a single drug, choosing among the options would not be a problem. However, most Medicare beneficiaries have multiple drug needs, so selecting a plan necessitates weighing the differing discounts and costs on several items. Undoubtedly, some medications would be better buys and others less attractive in any single plan, making the process of choosing a complicated one.

One helpful tool will be the Medicare website (www.medicare.gov) which will allow consumers to compare discounted prices on a large number of drugs from the competing discount cards. However, a great many Medicare beneficiaries do not have access to the Internet and may be left with no adequate means to determine which card best suits their needs.

While Holtz Rubenstein Benefits Consulting, LLC (HRBC) does not deal with Medicare benefits, it advises businesses on employee benefit programs, including dealing with issues of Medicare integration and retiree medical coverage. For more information, contact HRBC Director Mark Senders at 631-752-7400 x-355 or MSenders@holtzbenefits.com. 




New Jersey Tax Consequences of Failure to Dissolve Corporation

Do you currently conduct business in New Jersey and wish to cease operations? It involves more than just filing a final tax return. According to the New Jersey Division of Taxation, any corporation that ends business operations must be legally dissolved with the New Jersey Secretary of State if it wishes to avoid future tax liability for corporation income tax.



The dissolution is effective at the date the Division of Taxation receives the properly completed and executed articles of dissolution, payment of all taxes and fees, and notice of tax clearance. A tax clearance certificate provides notification to the taxpayer that all outstanding liabilities have been satisfied and the corporation can dissolve. All current tax eligibilities for the corporation will be ended as of the date the request for dissolution is received and accepted by the Division. However, any prior tax liabilities still will apply and be subject to review. If this process is incomplete and full payment of any outstanding liability is not received, the Division will issue notices and initiate further action against the corporation, which will include holding the corporate officers personally liable for unpaid taxes.

You may want to consult your attorney regarding this process. 

Post-Delivery Activities Create Nexus for Food Distributor

In a recent New York State advisory opinion, an issue was raised by a corporation, located in Pennsylvania, on whether it is subject to the New York State Corporate Franchise tax.



In this case, the post-delivery activities of a Pennsylvania food distributor that delivers goods to customers in New York go beyond the mere solicitation of orders protected by Federal Public Law 86-272 and, therefore, create nexus (a connection) for New York corporate franchise tax purposes.


The interstate income tax law, generally known as Public Law 86-272, provides that a state may not impose a net income tax on income derived within a state from interstate commerce if the taxpayer's only activity within a state is limited to the solicitation of orders.



The facts in the case are that the Pennsylvania company does not own, rent, lease, or maintain any real property in New York. The company's salespersons, who are not based in New York, solicit orders from New York customers that are subsequently processed in Pennsylvania. Once a week the company delivers products from its Pennsylvania warehouses to its New York customers via company-owned trucks. These activities do not make the company subject to tax.

However, the company's delivery personnel also pick up damaged products from New York customers that do not meet customer's specifications and return them to a Pennsylvania facility. In addition, delivery personnel sometimes pick up checks for the amount due from the previous delivery when delivering current shipments.

These activities subject the company to tax unless they are deemed to be *de minimus*. The advisory opinion stated that the company's post-delivery activities are not *de minimus* and establish a connection with New York.

Accordingly, New York State ruled that the company's activities in New York State are not exempt pursuant to the provisions of Public Law 86-272, and the taxpayer is subject to the New York State Franchise tax. 

DFK International Reports Record Fees

DFK International, the worldwide association of independent accounting firms and business advisers with which Holtz Rubenstein is affiliated, has reported a consolidated record fee income of \$492 million by its member firms in 2003. This is a 21% increase, as reported in International Accounting Bulletin's annual survey. The DFK national groups in the USA, Canada, Germany and the U.K. posted the highest growth.




"While some of the growth can be attributed to firms that have joined the network, once again our main increase has been achieved by the organic growth of our long term member firms," commented Holtz Rubenstein Senior Tax Partner Alan E. Weiner, who serves as Vice President of the Americas for DFK International, and who recently participated in its European members' meeting in Malta.

DFK International was established in 1962 and today has 155 member firms with 298 offices in major cities around the world. It recently admitted new member firms in Shanghai, Moscow, Stuttgart, Cairns (Australia), Columbia (South America), Las Vegas, NV, and Colorado Springs, CO. 

Index of 2003 HR Adviser Articles

It has been our pleasure to provide you with additional financial information in our newsletters in the past year. For your reference, we are offering an index of articles we published in 2003.

To access it, visit our website, www.hrcpa.com and click on the HR Adviser link under "Firm News."

For further information, please contact Marketing Director Flo Federman at 631-752-7400 x-212 or FFederman@hrcpa.com. 

DFK Firm Spotlight: Boyes, Wright, Pittman & Co., PC

DFK International is the worldwide association of independent accounting and business advisory firms in which Holtz Rubenstein is actively involved. Through our affiliation, we are able to provide enhanced services to you and to other clients throughout the United States and the world.


This issue we spotlight one of DFK's members in Michigan – Boyes, Wright, Pittman & Co., PC. We invite you to visit them at www.bwpc.com. 

IRS Waives IRA 60-Day Rollover Rule

IRA distributions are not included in gross income if the distributed amount is re-deposited into an IRA or other eligible retirement plan within 60 days of the distribution.

A waiver can be obtained for post December 31, 2001 distributions under certain circumstances, such as casualty, disaster, or other events beyond reasonable control of the individual subject to the requirement.

Recently, four letter rulings have been released by the IRS showing their flexibility in regards to waiving the 60-day rollover requirement for IRA distributions.

The IRS considers all facts and circumstances – such as, financial institution errors, inability to complete a rollover due to death, disability, or hospitalization, and time elapsed since the distribution occurred – in determining whether or not to waive the 60-day rule. 

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Notable and Quotable


both public and privately held companies in a variety of industries. He is a member of the American Institute of CPAs (AICPA), the New York State Society of CPAs (NYSSCPA), and the National Association of Tax Practitioners. He earned a B.S. degree in accounting from Fairfield University and currently is enrolled in the Masters program at C.W. Post.

Joining him in the emerging business department as a Senior Auditor is **Matthew J. Adduci**, who has 3 years previous experience providing tax, audit and compliance work for manufacturers, service industries, doctors and attorneys. He earned his B.S. in business management from SUNY Stony Brook and also attended SUNY Old Westbury.

Achraf Seyam is the newest addition to Holtz Rubenstein's not-for-profit department with 10 years experience in not-for-profit and government accounting. He is a member of the AICPA and the NYSSCPA and received his MBA from St. John's University.

The firm also welcomes **Maureen McElwee**, who is a senior tax accountant. Maureen relocated to Long Island from Connecticut, where she earned her B.S. degree in accounting from Sacred Heart University and spent 3 years in public accounting.

Ginamarie Dell'Anno comes to the firm at the entry level, straight out of Hofstra University, where she graduated with a B.B.A. degree in accounting.

The firm also welcomes **Brian Jones** to the administrative staff, in tax collation and the mailroom. 

To change contact information for the HR Adviser, please contact us at info@hrcpa.com.