

OUR PERSPECTIVES



Dear Clients and Friends:

Do you know what “the number” is? The number I speak of is the amount you need to accumulate in order to retire. More and more frequently, we are hearing about how social security will soon run out of money.

It is only a matter of time before benefits are cut in some manner to alleviate this potential bankruptcy. Also, 401(k) plans have replaced many traditional pension plans because of underfunding in the case of defined benefit plans, and lawsuits resulting from accused fiduciary neglect in the case of those and defined contribution plans.

*A friend recently called to tell me about a book called *The Number*. The author, Lewis Eisenberg, is neither a financial planner nor an investment advisor. In fact, the book doesn't really tell you what “the number” is. Instead, it offers a different perspective on retirement, essentially dealing with the kind of life you wish to lead when you get there. The book is thought provoking because it focuses not on money but on genuine life fulfillment—what do you really want to do with the free time that lies ahead?*

Who are you? What have you always wanted to do but you were too busy? Explore the world? Play golf? Perform charity work? Take courses or teach college? Although it may be difficult to make such decisions now, you need to start asking yourself these questions. Once you answer “the big question”—what kind of life will bring meaning and satisfaction to my retirement years— then you can work on determining “the number”.

Eisenberg does not address numbers. I, however, close with a reference to them. Whatever conclusions you come to regarding the way you wish to spend your retirement, only consistent saving and sensible investment will make that goal a reality.

*Very truly yours,
Michael S. Lewis, CPA
Managing Partner*

Data Loss: A Potential Killer

David Kerner

Did you know that 70% of companies who suffer serious data loss go out of business within 12 months? Also, according to a recent study, in 2005 76% of data loss was the direct result of human error and hardware failure, costing U.S. businesses in excess of twenty billion dollars. These are astonishing figures, yet so many companies and individuals fail to take the necessary steps to protect their data.

Whether you are a large corporation, a small business, or a home user, backing up your data is not a choice – it is a necessity. Additionally, we highly recommend that your backups be stored off-site, ensuring that your data is safe even if your business location is destroyed or compromised. There are many backup options available, and implementing at least one of them immediately can save you time, money, and headaches in the event of serious data loss.

There are two types of backups for you to choose from, and ideally, they

should be used together. A true “hard drive” backup makes a compressed copy of your data, operating system, and all of your programs. The “hard drive” is preferable because in the event of complete data loss you can quickly and completely restore your systems without having to reinstall everything manually. The second type of backup is a “data-only” backup. Once a full backup has been completed, “data-only” backups can be performed on a more regular basis, always providing you with the most current data on your systems. In the worst case scenario, your operating system and individual programs can be reinstalled and even repurchased, where your data, once lost, will be difficult—if not impossible—to recreate in its entirety.

Once you've decided on the type of backup, you must decide how and where to backup your data. The term “external storage” refers to any type of backup format that is not on your computer, such as a piece of hardware, software, or even a web service.

Data can be copied to a floppy

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Reasonable Compensation— The New Target

Jill Bruccoleri

In November of 2005, the IRS announced that they had performed more than 1.22 million tax return audits, the highest number in nearly ten years. Why the sudden and drastic increase in this type of audit? “Reasonable compensation” is a likely answer.

“Reasonable compensation”, a well recognized gray area by the IRS, is best defined as “wages that are ordinary and necessary, as well as reasonable, paid to owners, partners, and employees based on the services they have provided to the company”. In order for this compensation to be deductible, a company needs to determine what is considered “reasonable”, a tricky task. A few factors to consider when deeming compensation reasonable

include the qualifications of employees, their role in the company, the duties they will be performing, the relationship between gross and net income, salaries in relation to dividends, comparable salaries in comparable businesses, and salaries paid in prior years. Businesses that need to be particularly mindful of this hot topic are S Corporations and C Corporations.

In S corporations, owners can withdraw earnings in four forms: distributions, wages, repayment of loans, and reimbursed expenses. Since income from an S corporation passes through the business directly to the owners, compensation tends to be lower than normal. This produces a lower payroll tax liability for the corporation, as distributions from a corporation are not subject to FICA and Medicare taxes. Keep in mind, however, that the IRS can object to these distributions and deem the compensation unreasonable for being too low. The following are a few tips to prevent giving the IRS

ammunition to reclassify your distributions to wages:

- Pay officers and shareholders salaries that are standard in the industry;
- Record distributions in the corporate minutes every time a dividend payment is made;
- Pay all distributions on the same date, but no more than once a month;
- Refrain from paying out distributions if your company is losing money.

What constitutes “reasonable compensation” for C Corporations has been an ongoing thorn in the side of the IRS. Since all compensation is fully deductible in a C corporation, the issue is that too much compensation is being paid to “conceal” dividends, because dividends are taxed twice—at the corporate and then at the personal level. The IRS considers these “concealed dividends” as unreasonable wages and treats them as nondeductible by the company and taxable only at

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Liberalized Rules for Segregating Cost on your Real Estate Investments

Thomas J. Stickle, CPA

One of the great advantages of an investment in a real estate project held for rental is the ability to shelter income and defer taxes as the result of the annual depreciation deduction. The depreciation write-off of a real estate development in terms of methods and lengths of time allows investors to reap the benefits of cash flow while deferring a portion of their tax obligation. Upon purchasing a piece of real estate to be held for rental, the first step is to properly allocate a portion of the real estate to land and a portion to building. The amount allocated to the latter is the portion subject to

depreciation. An investment in a residential property (i.e., an apartment building) will be written off over a 27½ year term; an investment in any non-residential property over a 39-year term. Although the terms of the depreciation write-off are directly from the Internal Revenue Code, there is a way to depreciate an investment over a much shorter term. This method is called a “cost segregation study”.

A “cost segregation study” is a detailed analysis of a real estate purchase, new construction project, or substantial renovation. As a result of undertaking such a study, costs that normally would be required to be depreciated over 27½ or 39 years can be depreciated over much shorter lives, 5, 7 or 15 years. Each asset that can be reclassified is properly identified and segregated. This reclassification of the depreciable asset allows an investor to maximize tax

deferral and increase his or her current cash flow. These studies are accepted by the Internal Revenue Service and the benefits to you can be substantial.

A “cost segregation study”, available for new investments and new construction, can also be used for investments held for several years. The tax law permits taxpayers to claim all of the prior depreciation in the current year to “catch up” for deductions missed from the inception of the investment.

To ensure that the reclassification will stand up to IRS scrutiny, you must retain the expertise of an accounting and engineering firm. At Meisel, Tuteur & Lewis, we have been directly involved with many such studies and are available to assist you in present or future real estate investment projects. Contact **Thomas Stickle**, tstickle@mtlcpa.com, to discuss this opportunity further. ■

Are Hedge Funds Right for You?

Bradley E. Maneely, CPA

By now I have to assume that everyone has heard of Hedge Funds, since the press has been reporting aggressively about these secretive investment vehicles. Of course, to be of interest to the media, things tend to get sensationalized a bit. After all, how exciting is it to hear about a fund that has returned 10-12% net of fees to its investors for the past 10 years? From an investor's standpoint those are exactly the funds that I would like to hear about. Instead, we are bombarded by stories of a few bad guys who make off with their investors' money. So let's look at the question at hand: "if you haven't already allocated some of your investment dollars to a hedge fund, should you?"

Let's start with a brief introduction. The term "hedge fund" is used to describe an entity, usually a partnership, which pools investors' money and invests in anything with the potential to make a profit. Of course, these people are supposed to be the best and the brightest and therefore expect to be compensated competitively, usually an arrangement called "1 & 20", which is a 1% management fee and an incentive fee of 20% of profits.

What should you do? First, understand that these types of investments are not for everyone. Second, even if you are ready to invest some of your money here, make it a reasonable allocation of your portfolio. Do not—I repeat, **do not**—put all of your retirement, college education, or rainy day money into one investment vehicle. The next step—a hard one—is selecting a trustworthy fund. As the popularity of hedge funds has grown, so has their number; which, as you might expect, brings down the average return for the strategies as a whole. In fact, in 2005, according to the Credit Suisse/Tremont Hedge Fund Index, which tracks more than 4,000 funds, the return of all funds was up only 7.61%. That performance is not that impressive when you compare it to the S&P 500, which returned around 3%. Of course, included in these numbers are funds that did very well and funds that did very poorly. One way to mitigate risk is to invest in a basket of funds. A warning here: doing this on your own requires a huge amount of money. Therefore, the individual investor should look to diversify through either a fund of fund structure or invest in a multi-strategy single manager fund.

Where do you start? Once the decision to allocate dollars has been made, the next task is selecting the

manager—more of an art than a science. The following are a few tips about what to look for during your due diligence: audited financial statements, preferably the work of a large nationally recognized accounting firm; a track record of consistent performance, hopefully over a number of years which include both good and bad market cycles; the amount the manager has invested in the fund (it should be a large portion of his or her net worth); references from other investors, service providers, or prime brokers. Lastly, do the "gut" check; often it can be the most important of all.

In summary, I believe that hedge funds are extremely important to the diversified portfolio but must be included in moderation and with the realization that you must be a long term investor. I am growing increasingly concerned about the rapid growth in funds, because this further complicates the investment landscape and confuses the person who is looking for the "best" investment. I expect that the market for funds will consolidate considerably over the next few years if the returns continue to stagnate. If you do decide to invest, be sure to do your homework.

If you have any questions or would like to discuss your allocation to hedge funds or other alternative investments, contact **Brad Maneely, bmaneely@mtlcpa.com**. ■

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Reasonable Compensation – The New Target

the personal level. In order to avoid this problem, here are a few helpful hints:

- Develop structured and formal compensation agreements;
- Document the reasons for compensation amounts in the corporate minutes;
- Compare your compensation with others in your industry;
- Involve your tax advisors to determine whether a dividend should or should not be paid.

The key point regarding "reasonable compensation" bears repeating—compensation is only deductible to the extent that it is reasonable. Carefully consider whether the amount is too high or too low when deciding on compensation levels for your employees and yourself. As always, if you have any questions or concerns regarding this issue, please do not hesitate to contact one of the professionals at Meisel, Tuteur, & Lewis, P.C. ■

An Inside Look

Employee News:

Christine Maggi, a graduate of the University of Scranton, has joined us as a Staff accountant.

Jonathan Crate, a graduate of Rutgers, has joined as a Senior accountant. He specializes in real estate accounting and consulting.

Welcome back **Michael Gill**, who recently returned to the Firm after moving to California for a short time.

Marcia Britton and **Carole Schnell**, long-time employees of the Firm, have taken on new responsibilities within the Firm's Administration Department.

Mariea Vanikiotis, currently attending Rutgers University, has been hired as an Accounting Intern.

Engagement:

Congratulations to **Jill Griffith** and Christopher Kolk, who were engaged this past October. An October 2006 wedding is being planned.

Individual Achievements:

Managing Partner **Michael S. Lewis, CPA** has been invited to sit on Valley National Bank's Professionals Group Advisory Council.

Michael Napolitano, CPA is a founding member of the recently formed The Strategic Connection Chapter of Business Network International (BNI).

William Schwarz, CPA, MST and **Andrew Fink, CPA, MST** have both been published in the Biz Brain column of *The Star-Ledger*.

Congratulations to **Thomas Stickle, CPA**, for winning a trip to Lisbon, Portugal for his high level of participation in North Fork Bank's Chairman's Club program. ■

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Data Loss: A Potential Killer

disk, CD, DVD, or a ZIP drive, and most computers have at least one of these formats available. As a note, floppy disks are the least reliable format mentioned and are suitable only for short-term storage of small files, while DVD's hold the most amount of information. Additionally, backup software is available to assist you to automate the process of backing up to ZIP and DVD disks.

Another option is backing up to an external hard drive. External USB hard drives have become inexpensive and can hold large amounts of data. They are typically sold with backup software included, enabling you to automatically backup your entire computer on a regular basis.

For users requiring even larger amounts of storage space, tape backup systems are available, ranging from several hundred to several thousand dollars. One of its best advantages is that you can store the tapes off-site, ensuring

your data is safe even in the event of a disaster at your location. Online backup services offer you this same advantage and are becoming increasingly popular. They will securely store your data at their location for a monthly fee. This option requires a fast internet connection such as a cable, DSL, or a T-1 connection. One drawback is that if your internet connection is not working or if the backup company's servers are temporarily down, you will be unable to access, retrieve, or store your data.

Whichever backup method you choose, periodically confirm that it is working properly. Don't wait until it is too late to find out that you have no backup procedure in place or that it is not working as it should be. Finally, perform backups regularly. If you use your computer occasionally, a weekly backup might be enough. If you use your computer every day, then a daily backup is a good idea.

If you have questions concerning backup procedures, feel free to contact **David Kerner** at dkerner@mtlcpa.com. ■

Important Change for Filing New Jersey Annual Reports

Effective immediately, online filing of New Jersey Annual Reports is mandatory for all business entities. For businesses structured as corporations, annual reports will no longer accompany their year-end tax return and a new due date, based upon the date of formation, will be assigned. You should receive a notice from the state explaining the process. Armed with your 10-digit entity number, business type, and original filing date, you can file online at: https://www1.state.nj.us/TYTR_COARS/JSP/page1.jsp. Failure to do so may result in the revocation of your corporate charter. ■

Here's What's New in 2006

William Schwarz, CPA, MST

There are important tax changes taking effect in 2006, in addition to the usual annual changes due to inflationary indexing. Most of the non-indexing changes result from the Gulf Opportunity Zone Act of 2005 (GO Zone Act), the Katrina Emergency Tax Relief Act of 2005 (KETRA), and the Energy Tax Incentives Act of 2005 (Energy Act). However, they are also the results of prior legislation with phased-in changes or expiring provisions. This article summarizes some of the changes affecting individuals in 2006.

Itemized deduction phase-out reduced. Most taxpayer's itemized deductions are reduced when their adjusted gross income (AGI) exceeds an inflation adjusted amount. The phase-out is based upon their AGI and total itemized deductions. For 2006, the phase-out is reduced to 2/3 of the prior calculation.

Personal exemption phase-out reduced. A taxpayer's personal exemption amount is generally reduced by 2% for each \$2,500 of AGI in excess of an inflation adjusted threshold. However, for 2006, a taxpayer will lose only 2/3 of the amount which would otherwise be lost under the computation.

AMT exemption and phase-out amounts for individuals reduced in 2006. Unless extended, the alternative minimum tax exemption amounts will be reduced in 2006 from \$40,250 to \$33,750 for single/head of household and from \$58,000 to \$45,000 for married filing jointly/surviving spouses. That means it will be easier to run afoul of the AMT in 2006.

Residential energy credits. There are two new credits available for expenses paid in 2006 to have qualified energy savings items installed on your primary home. The first generally allows a lifetime credit of \$500 for making qualifying energy savings improvements to the primary residence (\$200 of which may be for windows). The second allows an annual credit for the purchase of residential energy efficient property (generally solar energy products). This credit can be as much as \$4,500 but varies depending on the types of property purchased.

Alternative motor vehicle credit. Taxpayers may be able to take a credit for the purchase of a hybrid or lean burn

vehicle in 2006. This credit may be as much as \$3,400 but varies depending on the vehicle purchased and, oddly enough, the amount of sales the manufacturer records. Thus, the dealer will have to provide the specific credit amount when the vehicle is purchased.

Six-month automatic extension. Most individuals will be able to request a six-month automatic extension for their 2005 return with the filing of a single form. Under prior rules, an individual had to request an initial four-month automatic extension and a second two-month discretionary one.

Educator expenses. The above-the-line deduction for educator expenses is not available for post-2005 tax years.

Tuition and fees deduction. The above-the-line deduction for higher education expenses is not available for tax years beginning after 2005.

Estate tax exclusion. The amount exempted from the estate tax by the unified credit has increased from one and a half million to two million dollars for 2006 through 2008.

This article highlights the 2006 tax changes that will affect the majority of taxpayers. If you have any questions related to these or any other tax changes, please contact one of the tax professionals at Meisel, Tuteur, and Lewis, P.C. ■

Electronic Filing Required for Some Corporations

For the 2005 tax year, corporations with assets of fifty million dollars or more who file at least 250 returns annually (this includes all returns, W-2's, 1099's, etc.) must electronically file their income tax returns. This rule applies to both regular corporations and S corporations. Beginning with the 2006 tax year, the asset threshold will be reduced to ten million dollars.

Should you have any questions regarding this rule, contact **William Schwarz** or your MT&L professional. ■