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TAX AND BUSINESS ADVISOR

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TAX AND BUSINESS Alert™

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Plan Ahead for Self-employment

If you are considering self-employment because of a pending layoff, job uncertainty, or just because it is the right time, you have a lot to plan for. So, please consider the following issues while making this important, life-changing decision.

Check for Noncompete Agreements. If you plan to continue in the same business as your present employer, make sure you have not signed anything that prevents you from dealing with the customers or clients you are counting on.

Continue Your Employee Health Insurance Coverage. It often takes time to find private health insurance at a price you are willing to pay. Unless your spouse can provide coverage through his or her employment, you can continue your existing coverage under your former employer's group plan by making a COBRA election. Generally, coverage is continued for up to 18 months at a cost not to exceed 102% of what it costs your former employer. Make sure you check ahead of time to find out what the COBRA cost will be so you can accurately budget your expenses.

Make Other Insurance Arrangements. Contact your insurance agent to discuss property and casualty, personal and business liability, disability, and term insurance needs. Some professional associations offer relatively inexpensive umbrella liability policies that insure against some things not covered by your other basic liability policies. These umbrella policies are generally worth investigating.

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Arrange for Credit before You Quit. Even though you may have excellent credit, the change in your status from employee to self-employed can make borrowing much more difficult until you have a track record from being in business for yourself. If you have a definite need to buy a new house or car or make other purchases that involve significant borrowing, do it before you quit your job. If you are considering refinancing your home, do it now.

(Continued on page 2.)

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(Continued from page 1.)

Even if you do not think you will need the money, it is also a good idea to consider taking out a home equity loan or line of credit now. The extra cash on hand can provide some cushion if your self-employment expenses turn out to be higher than expected or if the money does not come in quite as fast as you thought it would.

Conserve Cash. Before you actually quit your job, and for the first few months after you go into business for yourself, minimize your cash outlays so you can build up a margin for error. In the early months of a new business, revenues are often less than expected because you have to spend time in start-up activities and because at least some of the revenue you anticipated does not materialize. In addition, clients or customers do not always pay as quickly as you would like. You may also have underestimated your expenses. Two ways to deal with this are to (1) postpone spending money on things that are not strictly necessary (such as vacations or upgraded computer equipment) and (2) use your credit judiciously.

Make Sure Your Planned Home Office Is OK. Many people starting a new business plan to use an office in the home—at least in the beginning. However, do not automatically assume you can do this without any problems. A little-known fact is that quite a few cities have surprisingly strict limits on home-operated businesses. Similarly, many residential insurance policies have exceptions and exclusions if a business is operated within the residence.

Avoid Cabin Fever. If you are used to lots of interaction with people in your job, it may be a shock to go out on your own. If you have no employees, there can be little or no face-to-face contact for days at a time. Consider joining or becoming active in professional organizations or local groups. In addition to providing potentially valuable networking opportunities, such involvement will help provide the activity level that you are accustomed to and some needed diversions from your new business.

There is a lot to consider before making the plunge into self-employment. Please contact us to discuss ideas and methods to minimize the tax bill from your new endeavor.

College Costs Keep Skyrocketing

The cost of attending college continues to climb at an accelerated rate. The College Board (**www.collegeboard.com**) reports that 2009–2010 tuition and fees have risen significantly: private four-year colleges are up 4.4% (to an average of $26,273) from 2008–2009, public four-year colleges are up 6.5% (to an average of $7,020) from last year, and even public two-year schools are up 7.3% (to an average of $2,544) over the prior year.

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The average surcharge for full-time out-of-state students at public four-year institutions is $11,528. However, the report indicates that $168 billion in financial aid is available, and about two-thirds of all full-time students receive grant aid (not counting loans or work-study programs). The College Board estimates that, on an annual basis when tax benefits are included, students at private four-year schools received an average of $14,400 in aid, students at public four-year schools received $5,400, and students at two-year schools received about $3,000.

If you have children or grandchildren who are planning to attend college, let us help you develop a savings plan to cover those costs and show you how to take advantage of the appropriate federal income tax incentives.

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Bankruptcy—Advantages and Disadvantages

If bankruptcy is the only viable business solution, a business generally can use two types of bankruptcy proceedings. Under one, the business is liquidated, so that at the conclusion of the process the business no longer exists. Under the other, the business is reorganized and, hopefully, comes out of the bankruptcy as a viable business structure. Each type of bankruptcy has its unique set of advantages and disadvantages.

Chapter 7—Liquidating Bankruptcy. The biggest advantage to filing bankruptcy to liquidate is that the debtor gets a fresh start. All dischargeable debts are eliminated, and the creditors are absolutely prohibited from going back to the debtor to try and collect the debt. In addition, the liquidation is orderly when under the supervision of a single, independent third party. The debtor's assets are marshaled, the creditor's claims verified and accepted, the property sold, and the proceeds distributed based on the priority of the claims. Creditors cannot increase their take by taking preemptive collection action. In fact, under the preference rules, payments made to a creditor within 90 days of filing the petition can be recovered from the creditor.

The court will also ensure that a reasonable price is obtained for the assets, thus maximizing the value received. This can be particularly important when there are co-debtors or other guarantors that have an obligation to pay the debt if the debtor cannot. The debtor is spared the costs of responding to multiple collection actions, including lawsuits, since the bankruptcy court has jurisdiction over the entire case.

But Chapter 7 has disadvantages as well. Perhaps the biggest disadvantage is the cost. Bankruptcy is an expensive process, and the monies paid in professional fees, filing fees, and other costs could arguably have been better spent in reducing the debtor's liabilities. This may be particularly true when there are few creditors or when related parties have agreed to guarantee the debtor's liabilities. Another disadvantage is the time and effort of the bankruptcy process. Since the court will direct the liquidation, it is the court, not the debtor, that sets the schedule. If the creditors are also arguing over various issues, the time it takes to liquidate can be increased. This can prove to be inconvenient and frustrating, particularly if the debtor is trying to operate a new business.

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Chapter 11—Reorganization. The biggest advantage to using Chapter 11 to reorganize a business is the ability of the court to control the process. The debtor is given breathing room and is normally left in charge of the business. The debtor is also given the opportunity to develop the reorganization plan free of creditor pressure, although the creditors must ultimately approve it. Furthermore, the automatic stay provisions prevent creditors from taking legal action outside the bankruptcy reorganization that could harm the debtor or jeopardize a successful reorganization. Unfortunately, many reorganizations simply do not work and end up converting to liquidating bankruptcies.

The main disadvantage of Chapter 11 is the cost of the proceedings and the oversight that will be provided by the court and creditors. The debtor is under a duty to the court and the creditors to operate the business and must seek approval for any action outside the course of business. The debtor effectively operates in a fishbowl, which can be an unpleasant experience since most business owners are not used to having every decision scrutinized and second-guessed.

Obviously, tax and legal advice should be sought when contemplating bankruptcy. Please contact us for further guidance on this topic.

Save Taxes Using a Partial Annuity Exchange

Variable annuity contract distributions generally contain two components, taxable income and nontaxable return of basis (investment). However, distributions received before the annuity starting date (nonannuity distributions) are likely to be less taxpayer-friendly. Initially, these nonannuity payments generally consist entirely of taxable income until all of the annuity contract's earnings have been distributed. Subsequent payments are considered to be a nontaxable return of basis. Because of this issue, when an annuity owner must take a nonannuity distribution, the tax impact can be onerous.

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Internal Revenue Code Section 1035 has traditionally provided a federal tax-free mechanism to exchange one annuity contract for another annuity contract. This Section 1035 exchange, without recognition of gain or loss, is limited to cases where the person who is the insured or annuitant is the same in both contracts. Recent regulatory guidance offers a way to lessen the tax impact on nonannuity distributions using the Section 1035 exchange mechanism.

A person holding a highly appreciated annuity (one containing a large amount of built-up earnings) can lessen the tax bite using a two-step process. First, he or she makes a partial withdrawal from the original annuity by completing a partial exchange into another annuity. Next, he or she surrenders *either* annuity contract more than 12 months later to minimize the tax impact (see the following example).

Example: Partial Annuity Exchange. Pat originally invested $50,000 in an annuity, which has now grown to a fair market value of $200,000. If she withdraws $100,000 from this annuity, it is considered to be composed entirely of income and will be taxed as ordinary income. But, if Pat makes a Section 1035 exchange with half of the original annuity into a second annuity worth $100,000, there will be no immediate tax cost. Her basis in each annuity is split proportionally. Accordingly, she has a $25,000 tax cost (basis) in each $100,000 annuity after the partial Section 1035 exchange. If Pat surrenders one of the annuities in full more than 12 months after the date of the Section 1035 exchange, she receives a $100,000 distribution that is considered to be $25,000 return of basis and $75,000 of ordinary income. This is a better result than receiving $100,000 of ordinary income without the partial Section 1035 exchange.

Please contact us if you have questions about the tax aspects of annuity distributions or any other tax compliance or planning issue.