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It's in the Fundamentals

By Gregory R. Weichbrodt, MBA, ASA



During the debate over the United States' debt level, considerable volatility entered the financial marketplace. An influencing factor was Standard & Poors' decision to downgrade the United States' credit rating on August 5, 2011. After the company downgraded its credit rating on U.S. financial obligations to commercial creditors equity markets fluctuated greatly. A key factor in this volatility comes from the investment community's lack of clarity regarding the financial impact to public companies from such a downgrade.

The initial reaction by investors to news about the downgrade was negative. On the first trading day following the announcement, stocks broadly declined worldwide. In the days thereafter, stock markets fluctuated considerably. Why did this occur? Turning to financial basics, a credit rating is a perception of a borrower's willingness and ability to service debt on time and in full. When a downgrade occurs, the rater perceives greater uncertainty regarding whether contractual debt obligations will be satisfied. So it follows: the lower the credit rating, the higher the perceived risk and vice-versa. To compensate for an increased risk of borrower default on an investment, such as U.S. Treasury bonds, lenders generally charge higher interest rates. Increased rates on Treasury bonds may in-turn cause corporate bond rates to increase. The initial negative reaction, then, seemed rational in that investors may have believed corporate interest rates were headed upward, causing corporate debt expenses to increase (and profits to decline).

On the second trading day after Standard & Poors' downgrade, however, the reaction was positive as stocks broadly increased. The Federal Reserve announced it planned to keep the federal funds interest rate near zero for an extended period. There is a strong relationship between the federal funds rate and the Prime rate – the rate at which most corporate obligations are based. As such, investors concluded corporate interest rates may remain stable and were given some assurance that corporate debt obligations would not increase, a factor which likely caused stock markets to rebound. Throughout the week after the downgrade, investors were searching for additional clues from which they could make sound investment decisions. With each new piece of information, investors weighed its impact on their holdings and reacted.

The connection between Standard & Poors' credit rating and stock market volatility is cited to demonstrate that investors look to underlying operating fundamentals when making investment decisions. The factors which form the foundation of Standard & Poors' investment analysis appear parallel to investor decision making. Standard & Poors' article entitled:

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A Balanced Perspective

By John Wright

Recently, I was visiting with a friend and a question I hear often came up – what is your take on the local market? Clearly, business leaders are seeking input from valued peers because we all seem to be battling the same daily blend of negative media reports, lukewarm (at best) predictions for the coming months, and the reality of what we see every day in our own businesses. Much like a weather pattern – the heat, which really hasn't changed all summer, is feeling hotter every day. The lack of rain becomes more obvious as each day passes with little to no moisture. Having grown up in an agricultural family, I understand how weather conditions affect daily decisions of a farmer or rancher. Great consideration is given to the conditions over the past months, the current day, and more importantly, the anticipated future. Seeing the business of my dad and grandfather subject to so much that was simply out of their control was definitely an interesting way to grow up.

Our businesses are facing the same heat and drought conditions today. Market indicators and our own daily experiences have been less than positive for some time, so it's impacting how we, as business leaders, are making decisions. While there is some investment and growth-driven activity, there doesn't seem to be any consistency or sustained action across industry segments. Much of what we are seeing is businesses making conservative decisions based on a very uncertain and unstable marketplace. The

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Healthcare Reform: Yesterday, Today, and Tomorrow

By Cyndi Mergele, SPHR, PI



It has been 18 months since the Patient Protection and Affordable Care Act was passed and, while much debate regarding the repeal of the Act occurred during the last mid-term elections, the provisions of the Act continue to be enacted as scheduled.

Changes To Date

The first wave of provisions that affected employer-sponsored group health plans involved quality improvement, cost savings, consumer protections, and increasing access to care. The relevant provisions enacted in 2010 included:

- Prohibitions against denying coverage to children under the age of 19 due to pre-existing medical conditions (effective for plan years beginning on or after September 23, 2010)
- Elimination of lifetime limits on essential benefits (effective for plan years beginning on or after September 23, 2010)
- Restriction on annual limits for all group plans (effective for plan years beginning on or after September 23, 2010)
- Small business health insurance tax credits
- Coverage of certain preventive services without charging co-payments, co-insurance, or deductibles (effective for non-grandfathered plans beginning on or after September 23, 2010)
- Extending coverage of dependent children to age 26 (effective for plan years beginning on or after September 23, 2010)
- Requirement that at least 85% of all premium dollars collected by insurance companies for large plans are spent on healthcare services and healthcare quality improvement. For small plans, at least 80% must be spent on healthcare services and healthcare quality improvement. If insurance company administrative costs are too high or profits are too high, rebates must be provided to consumers (effective January 1, 2011).

What's To Come?

A number of future provisions are aimed at cost savings and quality improvement directed at Medicare and Medicaid programs, as well as physicians and healthcare organizations. Provisions that will affect employers include:

- Reporting the cost of health insurance on employee W-2s (optional for 2011, pending guidance from the Internal Revenue Service for reporting going forward)
- Non-grandfathered plans will be required to cover women's preventive services to include contraception, without charging co-payments, co-insurance, or deductible (effective for plan years beginning on or after July 31, 2012)
- Employers with 50 or more full-time workers will be required to provide adequate healthcare or pay a penalty if the employees receive premium tax credits to buy their own insurance. The penalty will be \$2,000 annually per full-time employee beyond the employer's first 30 employees (effective January 1, 2014)
- Prohibitions against discrimination due to pre-existing conditions or gender; specifically, reforms that will prohibit insurance companies from refusing to sell coverage or renew policies due to pre-existing conditions. For small groups, the provision eliminates an insurance company's ability to charge higher rates due to gender or health status (effective January 1, 2014)
- Elimination of annual limits on annual dollar limits for new and existing group plans (effective January 1, 2014)
- The establishment of Affordable Insurance Exchanges would permit employees whose employers do not offer insurance, or who are unable to afford coverage provided by their employers, to use what funds would have been provided by their employers to purchase coverage through the Exchanges (effective January 1, 2014)
- Increase in the Small Business Tax Credit from 35% to 50% of the employer's contribution (from 25% to 35% for small non-profits).

As the rules for many of the provisions have still not been created, employers should expect increased reporting requirements will be required to show evidence of compliance.

Will It Be Repealed?

There have been numerous court challenges to the constitutionality of certain provisions of the Patient Protection and Affordable Care Act. While various courts have ruled on both sides of the argument, it may ultimately take a decision by the U.S. Supreme Court (assuming the Court agrees to hear the case) to determine the constitutionality of the Act. In the meantime, employers should continue to prepare for the upcoming provisions.

It's in the Fundamentals

By Gregory R. Weichbrodt, MBA, ASA – *continued from page 1*

Sovereign Government Rating Methodology and Assumptions, dated June 30, 2011 can be found at www.standardandpoors.com/ratingsdirect. The article presents a multifactor analysis documenting the company's rationale on investment rating. The methodology is applied in the company's rating of U.S. debt in the article entitled: *United States of America Long-Term Rating Lowered to 'AA+' On Political Risks and Rising Debt Burden; Outlook Negative*, dated August 5, 2011. Standard & Poors' cited

two primary factors in their decision to downgrade U.S. debt: a rising public debt burden and their perception of greater policymaking uncertainty. Its outlook for the U.S. debt trajectory as a percentage of gross domestic product is upward and the company believes there is no clear policy in place that will alter this course. Whether one agrees with Standard & Poors' downgrade decision, financial fundamentals and future expectations appear to be driving investment decisions.

Do You Know Your Business Risks?

By J. Leo Muñoz, CPA, CFE



Even the most established long-standing businesses face new business risks each year. A recent example of a risk that became a reality for such a company was the oil rig explosion in the Gulf of Mexico that BP Petroleum would rather forget, but can't, due to forty billion reminders and counting.

The concept of "Enterprise Risk Management," or ERM, is nothing new, but seems to be a concept that receives press for a time after a significant economic downturn or a series of large corporate scandals. Then after the dust settles, ERM becomes an afterthought until the next big downturn.

Truth is businesses of all sizes that have defined goals and strategies for success face risks that may keep them from achieving these goals. Typically, an organization's management may create a plan with defined steps and milestones towards hitting its corporate operational and financial targets, but fails to include a plan to define and mitigate relevant risk tied to these targets. And, with a limited supply of time allocated to normal business processes, ERM tends to be pushed off to the side if it's thought of at all.

ERM is a process designed to (1) identify potential events that may affect an entity, (2) manage risk within an entity's risk appetite, and (3) provide an entity with reasonable assurance regarding the achievement of objectives. ERM frameworks exist that provide guidance in organizing and implementing an ERM process. The ERM process encompasses the following steps.

Risk identification – Knowing its critical business objectives (short or long term), an entity attempts to identify the universe of events that pose a risk towards achieving its objectives. Risk can be internal and/or external and may include categories such as market, legal, environmental, regulatory, fraud, financial,

and operational. An entity may look back into its history and identify an incident it does not wish to repeat.

Risk Assessment – Once risk is identified, an entity assesses the likelihood and measures the impact of the risk; both qualitative and quantitative determinations can help with the assessment.

Risk Response – Based on assessment, management can decide how the entity will respond in mitigating the risk. Depending on management's risk tolerance, response may include avoidance, possibly reducing the risk with insurance coverage, sharing the risk through outsourcing or accepting risk without any action other than identifying it exists.

Risk Monitoring – Steps one through three are a waste of time if management does not follow through with step four in monitoring the risk identified. Regular and effective monitoring measures and reporting can be the difference between being proactive and reactive. Key Risk Indicators (KRIs) can play an important role in management monitoring risk.

The perception about implementing an ERM process is that it's only a large company concern or it may be too complex, our internal audit department handles ERM, or it's time consuming. Often these perceptions and others are the barriers that keep management from following through with a focused and consistent process in assessing enterprise-wide risk.

An effective ERM process needs to have buy in from the top to succeed. Any business process worth the investment of time, effort and collaboration requires the executive team's support and ERM is no different. Given the choice between two alternatives, I would guess BP would rather have spent the time and effort towards assessing and possibly preventing the risk of an oil rig blow out in the Gulf of Mexico than the reality it's faced since Deepwater Horizon exploded on April 20, 2010.

A Balanced Perspective

By John Wright – *continued from page 1*



end result is conservatism which keeps businesses buying at the minimum, mostly making investment in internal infrastructure or assets, with a focus on replacement of assets which were held a little too long when the growth valve shut-off in 2008. Additionally, we see businesses using this time to get back to basics – streamlining processes and creating efficiencies in operational and administrative areas. These

are good basic focuses and undoubtedly, will bring about gains in bottom-line revenue. Creating better quality systems and reengineering processes have also helped put margin back into businesses where sales were flat, or even down.

As I reflect on my childhood years, I realize this is exactly what my dad and grandfather would have done. When subjected to similar external factors, in their case the weather or market, they focused their efforts on improving equipment, developing

new strategies for capturing water runoff to recycle back into the irrigation process, identifying new and/or different rotational crops for better soil nutrition, and so on. In the end, the droughts broke, fall came, and the heat subsided. Weather patterns returned to normal and my dad and grandfather were in a better position when the hard times passed. I now realize that while cycles may seem short, such as a 6-8 month wheat growing season, they are actually quite long, usually covering a span of several years. During this time, one can experience full rotations of various crops and manage through differing weather patterns or weather events. Maintaining an unshaken perspective requires patience, steady leadership, vision, and adaptability.

The same is required of businesses today. The cycle we are currently in will most assuredly change. The efforts we have put forth to create more efficient, higher quality, and varied products and services will come to serve as the key to our long term success.

DUE DATE CALENDAR

OCTOBER

OCTOBER 11

Individuals:

Form 4070 for employees who received \$20 or more in tips during September is due to employers.

OCTOBER 17

Individuals:

Last day for individuals who received an automatic six month filing extension to file 2010 income tax return (Form 1040 series), as well as to pay any tax that is due.

NOVEMBER

NOVEMBER 10

Individuals:

Form 4070 for employees who received \$20 or more in tips during October is due to employers.

NOVEMBER 15

Corporate:

Extended Corporate Texas Franchise Tax Return is due.

DECEMBER

DECEMBER 12

Individuals:

Form 4070 for employees who received \$20 or more in tips during November is due to employers.

DECEMBER 15

Corporate:

Deposit the 4th quarter of corporate estimated income tax for 2010 (use Worksheet Form 1120-W).

Tax Implications of Market Losses

By Dana M. Gasperek, CPA



Losses in your investment portfolio, retirement plans, or college saving funds are difficult to endure.

Understanding Capital Losses

A capital loss occurs when an investment (stocks, bonds, mutual funds) is sold for less than what was originally paid for it. Capital losses can offset capital gains in the same tax year. If losses exceed gains for the

year, \$3,000 in net capital losses can be deducted against ordinary income. Remaining capital losses can be carried over indefinitely to future tax years.

First, capital losses are used to offset capital gains: If you have a \$5,000 capital loss, and a \$5,000 capital gain, they will offset each other.

Second, \$3,000 of a capital loss can be used to offset ordinary income: If you have a \$5,000 capital loss and no gains, you can use \$3,000 of the capital loss to deduct against ordinary income.

Third, any capital loss that is not used in one year can be carried forward: If you have \$5,000 of capital losses, you can use \$3,000 of it to offset ordinary income, and \$2,000 will carryover to the next tax year. Next year, if you have \$5,000 of net capital gains, you can use the \$2,000 capital loss carryover to offset the \$5,000 of gains.

Wash Sales Defer Losses Until the Replacement Investment Is Sold

Investors may be tempted to sell stock when the value has declined to take the capital loss on their tax return, but then buy it back right away because they want to keep the stock until the value bounces back. Unfortunately, the “wash sale rule” prevents an investor from deducting a loss on a sale of stock if the same or substantially identical securities are bought during the period from 30 days prior

to or 30 days after selling that stock for a loss. The disallowed loss is added to the cost basis in the new stock and therefore, it is not lost forever – the loss is deferred until the new stock is sold. The wash sale rule also applies to mutual funds.

Example of how the wash sale works: Jeff holds 100 shares of Widgets Inc. stock with a cost basis of \$1,000. On August 31st the stock is worth only \$5 per share, and he sells all 100 shares for a capital loss of \$500. If Jeff purchases new shares in Widgets Inc. in the period from 30 calendar days before (the month of August) to 30 calendar days after August 31st (the month of September) then Jeff’s capital loss is deferred until the new, replacement shares of Widgets Inc. are sold.

Consider a Roth Conversion

One option to consider if an Individual Retirement Account (IRA) drops in value is to convert some (or all) of the IRA into a “tax-prepaid” Roth IRA. If the IRA has a low value at conversion, the tax at conversion is lower.

With Roth IRAs, you basically agree to pay any tax now in exchange for tax-free treatment when the funds are withdrawn later. When is it a good time to convert a traditional IRA to a Roth? The answer is complicated and depends on what the tax cost of converting to a Roth will be, whether converting to a Roth will save or cost money over the long-run, and how much to convert.

Cost Basis Reporting Beginning in 2011

Beginning in 2011, brokers will begin to report the cost basis of stocks, bonds, mutual funds, and other investment products on Form 1099-B. Basis reporting phases in and starts with stocks acquired on or after January 1, 2011. Basis reporting for mutual funds, stock dividend reinvestment plans, and other securities are phased in after 2011. To make 2011 tax return preparation more onerous, transaction details are reported on the new IRS Form 8949, *Sales and Other Dispositions of Capital Assets*, with various totals carried to Schedule D.

New Tax Laws Could Mean Substantial Penalties for Your Business

By Elizabeth Sabol, CPA

One often-overlooked provision of last year's health care bill (more officially known as the 2010 Health Care and Education Reconciliation Act) was an addition to the Internal Revenue Code prohibiting tax benefits from transactions lacking economic substance. Economic substance, which has been established in the court system for years, requires that transactions should have an effect on a taxpayer's economic position to be valid. Why was this seemingly-arcaic tax rule included in this bill, and what does this mean for your business?

Simply put, this is intended as a revenue-generator for the federal government. Congress' Joint Committee on Taxation has estimated that this provision will raise \$4.5 billion through 2019. Transactions without economic substance are subject to a 20% "substantial underpayment" penalty. The "substantial underpayment" penalty jumps to 40% when the transaction is not disclosed to the IRS. Written advice from your advisors, even if it meets the more-likely-than-not standard, is no longer a valid defense against these penalties if the transaction is determined to not have substantial economic substance. Clearly, the potential cost of noncompliance is significant. But what transactions do these rules apply to?

It's helpful to first consider the history of these transactions in the courts. Transactions that do not substantially alter a taxpayer's economic position and lack any business purpose other than tax avoidance, even if the transaction complies with the letter of the Internal Revenue Code, have been successfully challenged by the IRS for decades. This doctrine, however, was unevenly applied in various jurisdictions. By incorporating these rules into the Internal Revenue Code, Congress attempted to add consistency to and clarify the application of this principle.

Under the new rules, a transaction will only be allowed if it satisfies both elements of a two-prong test:

- 1) The business's economic position changes in a meaningful way (other than income tax effects) as a result of the transaction. (What risk is taken in the transaction?)
- 2) The taxpayer has a substantial purpose for entering into the transaction, other than tax avoidance. (What is the business intent for entering into the transaction?)

By applying a stricter test requiring taxpayers to prove both an objective change in economic position and a subjective business purpose, Congress hopes to strengthen its case against these so-called "sham transactions". A business should determine that each business transaction has economic substance.

Notably, the law specifically does not alter the courts' latitude in determining when economic effect applies – it merely codifies the manner in which it's implemented. Because of this, certain business transactions, having long been respected by the courts despite being largely driven by tax advantages, will generally go unchallenged. Decisions such as type of entity selection and corporate reorganization, deciding to capitalize a business with debt or equity, and utilizing a foreign or domestic corporation for overseas investments have been established as valid business transactions. This will not change under the new rules.

Given the potential consequences of the application of these rules – including the above-mentioned penalties and required FIN 48 financial accounting disclosures and the IRS's disclosures related to uncertain tax positions – it's important that anyone evaluating a proposed transaction work closely with their tax advisors to identify potential pitfalls. Padgett, Stratemann & Co. LLP tax personnel can assist you in determining if a particular transaction has substantial economic effect.

Skeets & Eats 2011

Thank you for making it another great Skeets & Eats event!



Lonsdale Selected as Firm's Newest Partner



Pat Lonsdale, CPA

Padgett Stratemann is pleased to announce the admission of Pat Lonsdale as its newest Partner. Pat is a CPA with over 11 years public accounting experience. He has worked with both privately-owned and publicly-traded entities and focuses on the manufacturing, retail, distribution, and construction industries. Pat received BBA's in Accounting and Information Systems from the University of the Incarnate Word and currently serves as the leader of the firm's Manufacturing, Retail, and Distribution niche.

Pat and his wife, Leslie, have two children with a third on the way. When he's not spending time with his family, Pat's hobbies include – in no particular order – fishing, hunting, fishing, fishing, hunting...and maybe a little golf.

The firm would like to thank Pat for his contributions to-date to the success of our organization. We look forward to his continued involvement in helping us meet the needs of our clients and our community.



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