

# focus

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A thief among us

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# How to curtail employee fraud

**T**he Association of Certified Fraud Examiners estimates that employee fraud accounts for nearly \$1 trillion in losses each year. Workers may commit a variety of crimes, ranging from misappropriating assets to stealing supplies. There's no guaranteed way to stop your employees from committing fraud, but you can slow them down.

## Profile of a fraudster

Most employees who commit fraud aren't your typical criminals. Many of them are trusted employees, who, for whatever reason, choose to embezzle funds or otherwise defraud you because they've either gotten into financial trouble (especially true in tough economic times) or they see a window of opportunity and the temptation is too hard to resist.

Some employees may justify their actions by convincing themselves that they're just "borrowing" the funds or even that the company owes it to them. Others are motivated by a desire to live a more extravagant lifestyle.



## At-risk functions

A variety of company functions are particularly vulnerable to fraud:

**Accounts payable.** Employees may forge checks to themselves, accept kickbacks from vendors, pay personal bills with company funds, or create and pay bills to fictitious suppliers.

**Accounts receivable.** Workers may grant fake credits or take fraudulent write-offs for bad debts.

**Cash management.** Employees may steal cash on hand, divert cash receipts or alter bank deposits.

**Payroll.** Workers might pay nonexistent employees, pad time records, falsify salaries or commit withholding fraud.

**Inventory and fixed-asset management.** Workers might steal company assets; divert and sell shipments; or use job materials, tools or other assets for non-job-related purposes.

***Take steps now to close off access and eliminate opportunities to commit fraud.***

In each scenario, the employee simply pockets the money and keeps his or her fingers crossed that no one will find out. But if you work with your CPA to create effective internal controls, you'll be able to locate the areas in which fraud is being committed.

Your CPA can also show you how to monitor bookkeeping records, invoices, bank statements, payments, journal entries, financial reports and other documents so you can catch subtle changes before too much money is siphoned off. Your accountant also can perform scheduled and surprise audits to identify potentially dangerous gaps in your controls and procedures.

### Close windows of opportunity

All too often fraud occurs because of easy access. Take steps now to close off access and eliminate opportunities to commit fraud. For example, separate accounting and finance-related responsibilities among several employees. Don't have the same worker in charge of receivables and cash deposits. Make sure your company's internal control system provides appropriate approvals and sign-offs prior to all checks being written. And cap the dollar amount for checks to be signed by an employee without additional approval.

Establish a fraud policy that explains what constitutes fraud and how management will deal with employees who are caught in the act. The policy should spell out the investigative process and make clear that, for specified severe violations, perpetrators will be terminated and

prosecuted. Make clear your company's penalties for infractions, as well as the civil and criminal penalties.

Consider implementing a fraud prevention plan that, among many things, addresses fraud risk reviews and awareness training. Moreover, establish an anonymous reporting hotline for employees to use if they suspect fraud.

### An ounce of prevention

Employee fraud doesn't influence just your bottom line; it can also negatively affect employee morale and require a lot of time to investigate and repair damage. Though it's nearly impossible to stop fraud from occurring, you can take steps that will not only make offenders think twice about committing it — but also catch them in the act if they do. ♦

## Are your independent contractors truly independent?

In today's belt-tightening economy, some businesses are replacing downsized workers with independent contractors (ICs) to eliminate the costs of maintaining full-time employees. But just because your company considers workers as ICs doesn't mean the IRS will. It's critical that you understand IRS guidelines to ensure your ICs truly are independent, or they could be much more costly than you bargained for.

### Get clear

Companies use ICs because they can get the service without the overhead. Employment laws don't require you to pay them overtime or minimum wage — or provide them with mandatory employee benefits — as is required for regular employees. Moreover, you don't need to withhold and pay federal, state, Social Security (FICA) and Medicare taxes on behalf of ICs.

But making the distinction between an IC and an employee can be tricky. And if you incorrectly classify an employee as an IC,



the IRS could hold you liable for the taxes that should have been paid or withheld for that worker, and penalize you for not doing so. Let's look at an example to help drive home this important point.

ABC Corporation added several ICs to its telemarketing center. The workers signed agreements stating they'd work for a certain fee and be responsible for paying their own FICA, unemployment and workers' compensation taxes.



Unfortunately, ABC made the mistake of integrating the ICs into the company, including allocating them office space and using company managers to oversee their work. ABC thought the signed agreement protected them, but the IRS considered it hollow because, in nearly every way but compensation, the company treated the ICs as employees.

As a result, ABC had to pay the ICs back employment taxes and the value of health insurance, 401(k) and other benefits for the period they worked. And ABC had to pay those costly IRS penalties.

### Avoid trouble

The distinction between employee and IC typically is determined by the amount of *control* the company has over the way in which the individual works and by the *support* given to that individual. To steer clear of IRS trouble, explain your desired results to the IC and provide a deadline, but leave the how, when and where the work is done to the IC. And be sure that the individual uses his or her own transportation, equipment and supplies.

Here are several other guidelines to help protect your ICs' independent status:

**Require invoices.** ICs should give you a total cost estimate for their work, rather than just an hourly or monthly rate. Ask them to submit invoices on completion or a series of invoices if the work takes more than a month or two. At year end, file a Form 1099-MISC for each IC to whom you paid at least \$600 during the year.

**Look for professional operations.** ICs should have their own workspace and resources. Like other professional businesses, they should market their services and carry business insurance. Use ICs who work for other companies besides yours. Otherwise, if his or her tax return includes only one Form 1099-MISC, the IRS might challenge his or her IC status.

**Be mindful of industry norms.** The IRS knows that some industries hire ICs more than others. For example, builders often hire independent carpenters, electricians and other tradespeople. If your industry doesn't typically use ICs, diligently follow the basic control and support rules as well as those regarding invoicing and hiring professionals.

Finally, consult an employment law attorney to develop a policy for hiring ICs, and have him or her prepare work-for-hire contracts for use with all ICs.

### Go by the book

Using ICs can be a cost-saving option for your company, particularly during this tough economic climate. But take precautions to ensure your independent contractors are truly independent. Keep accurate records of all work performed by and money paid to your ICs so that, if their classification is ever questioned, you'll be able to substantiate their status. ♦

### Protect your benefit plans

If a benefit plan excludes independent contractors who are later reclassified as employees, they may be entitled to retroactive benefits, which could be costly to your company and even jeopardize the tax-qualified status of your employee benefit plans. For example, if a reclassified employee is entitled to benefits from a 401(k) plan or defined benefit plan, you'd have to retroactively include the worker in the plan, make a retroactive contribution as required under the terms of the plan, and make an additional contribution of annual interest and earnings.

To maintain the plan's tax-qualified status, you'd likely need to correct certain operational failures of the plan, as prescribed by the IRS. And you'd need to rerun nondiscrimination testing for the plans and possibly amend Form 5500 filings. Other benefit plans may also be affected, including Section 125 plans, group health and term life insurance plans, and incentive stock option plans. Be sure to examine the terms of these plans and, if necessary, amend them.

# Be cautious when asking for business loans from family members

If you own a family business, you may be tempted to use your family members as a source of capital. But if these family financial arrangements aren't handled with care, they can end up doing more harm than good.

## Double-edged sword

Receiving money from family members can be like a double-edged sword: For tax purposes you may structure the transactions as outright gifts or as loans. But too much debt from these loans can signal bankers and potential investors that your business is financially unstable. In most cases, the bank will insist that the loans be subordinated to the bank's senior debt. Plus, it will want to review the promissory notes to ensure they contain the appropriate provision.

A business that's thinly capitalized (also referred to as overleveraged) because most of its funds are from loans rather than capital contributions can send bankers and potential investors packing.

In addition, if the IRS considers your family business's debt to be high compared with its capital contributions, it may recharacterize the debts as equity, resulting in a disallowance of interest expense and higher corporate taxes. Further, treatment of payments to stockholders will be reclassified as dividends, resulting in higher individual income taxes.

Make sure you examine your debt-to-equity ratio regularly to see whether you're thinly capitalized. If your debt is still too high, you may need to take measures to withstand IRS scrutiny. Establish a pattern of reducing your debt-to-equity ratio during the year. This will usually satisfy the IRS that your company's financial footing is sound. Also consider replacing family debt (or other shareholder debt) with bank financing that's guaranteed by family stockholders.

## Word to the wise

If you do accept loans from family members for your business, treat these debts the same as you would if you held them with outside investors or lenders. The loans should carry



interest at no less than IRS-prescribed rates. For multiyear loans, the rate is set monthly by the IRS based on the number of years in the note.

Meanwhile, demand loans, which have no stated term and thus are payable on demand, have a varying monthly interest rate. Keep in mind that loans must carry interest equal to the IRS rate; otherwise, you'll have to "impute" the interest at that rate.

Let's say your family business owes money to a related shareholder. If the interest rate is less than the IRS-prescribed rate, he or she must treat the interest as a dividend or distribution. But if the lender has no ownership in your company, you can treat the interest as income with an offsetting interest expense instead of a capital contribution and distribution.

Finally, make sure family loan agreements are legally binding notes and establish a pattern of regular repayments. Finally, reflect this information in your financial reports and company minutes.

## Consider the ramifications

Although asking family members for a business loan is common, you must treat the debt the same as you would if you held it with outside investors or lenders. Work with your CPA in structuring the transaction so it can withstand IRS scrutiny. ♦

# Joint tenancy arrangements carry significant risks

**C**reating a will entails taking a careful and sobering look at exactly who should receive your assets after your death. And it typically costs money in attorneys' fees and financial advice. One way some individuals sidestep the formalities of a will is to place property in "joint tenancy with the right of survivorship." Under this arrangement, the property is co-owned by two parties, with ownership ceding to the surviving owner upon one party's death. Although it sounds simple, joint tenancy carries significant risks.

## Legal conflicts

For this article's purposes, let's say the property is a house owned by Gerald, a retired divorcee with one son, Tommy. Gerald has an attorney draw up a deed naming himself and Tommy as joint tenants with right of survivorship. By adding his son to the title, Gerald will have just made a "gift" to Tommy, triggering the need to file a gift tax return. This is true even though — as in Gerald's situation — there's no gift tax payable as a result of the transfer.

Gerald assumes a bit of risk as a consequence of the transfer. First, he's no longer the sole owner, so Tommy has certain rights with respect to the property, which could come

into play if someone falls on the property and sues both Gerald and Tommy for damages.

Second, Gerald faces certain risks if conflicts arise between him and Tommy over ownership of the house. Say Gerald wishes to remarry, sell the house and move away. He would need Tommy to sign off on the sale. If Tommy doesn't want to, Gerald could have little recourse. Although undoing a joint tenancy with rights of survivorship isn't impossible, it won't resurrect Gerald's sole ownership of the property.

## Medicaid disqualification

If at some point Gerald must go into long-term care, he may need to confront the issue of qualifying for Medicaid. Unfortunately, this, too, can be affected by joint ownership with his son.

Federal law temporarily disqualifies any Medicaid applicant who has transferred property for less than full fair market value during a "look-back" period (typically three years before the application). Thus, if Gerald transfers an interest in his residence to Tommy, it will trigger this disqualification period. It could even result in Medicaid considering the entire value of the house as a "countable resource."

## Unexpected tax liability

Gerald may also face potential income tax consequences of his actions. Under joint tenancy with the right of survivorship, when co-ownership of property is granted to another party, the tax basis of that property comes along for the ride. Let's look at two scenarios that illustrate possible tax consequences:

**Sale of home during Gerald's life.** A year after adding Tommy's name to the title, Gerald decides to sell the house. When the sale occurs, Tommy must pay tax on his share of the gain. Suppose Gerald's tax basis was \$100,000 when he added Tommy to the title. They later sold the house for \$400,000, without having made any additional improvements. Tommy's 50% interest would have a \$50,000 tax basis. He'd get his share of the



sales proceeds and would have a taxable gain of \$150,000. Because Gerald meets the requirements for excluding gain on the sale of his principal residence, he wouldn't have a taxable gain on the sale.

As a family, though, they would have been subject to *less* income tax if Gerald had held onto the property and sold it without adding Tommy to the title. Gerald could exclude \$250,000 of the gain, leaving only \$50,000 subject to tax, and then use the cash to make a gift to Tommy.

**Sale after Gerald's death.** In this scenario, even though Tommy was a joint tenant, the

entire value of the house would be included in Gerald's taxable estate. Tommy would thus enjoy a "step-up" in basis equal to the property's fair market value at the time of Gerald's death. If the property is worth \$400,000 at the time of Gerald's death, when Tommy subsequently sells the house for that price he'd have no gain as a result of the sale.

### Look before you leap

Joint tenancy with the right of survivorship can be an effective way to share and eventually transfer property to a loved one. But there can be pitfalls. So "look before you leap" with this particular estate planning strategy. ♦

## Mom, Dad, we need to talk

### Why it's necessary to discuss finances with aging parents

Talking with aging parents about their finances can be emotionally taxing for them — and you. They're likely grappling with tough decisions that force them to confront their own mortality, such as who will receive their assets when they're gone and who will be in charge of their estate. You're likely grappling with the same thoughts. But with some advance planning — and a lot of sensitivity and respect — you can help your parents manage their emotions *and* their finances.

To help ensure your parents' financial stability, take time to discuss:

**Long-term care insurance.** These policies help cover what your parents' health insurance policies and Medicare won't, such as assisted living arrangements, nursing home residence and long-term home care.

**Reverse mortgage.** Under this arrangement, a lender makes payments to your parents for their home's equity, and the proceeds generally are tax free. The loan isn't due until they sell the home or die. The bank obtains ownership only through foreclosure.

**Medicaid.** This is a government-assisted, welfare-like program for individuals with a low net worth. To qualify, your parents must have depleted virtually all of their assets.

**Ownership interests.** If your parents have ownership interests in a family business, there are several options available to transfer those interests to their heirs, including a gifting program or an installment sale. Or they can do more sophisticated planning, such as setting up a grantor retained annuity trust, which allows them to receive annuity payments and offers potential tax benefits.

While your parents are of sound mind, encourage them to appoint a trusted individual as their power of attorney to make decisions about their finances when they're unable. Although your parents may initially think of appointing you or one of your siblings to fill the role, that may not be the wisest path to take. Many families can attest to the fact that asking one child to take on the power of attorney can pit otherwise loving brothers and sisters against each other.

Although it may be more costly to have a professional advisor to fill the role, it may be the safest route to take.