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MICROCAP COMPANIES: DARK ALLEYS IN THE WALL STREET

Richard Chen, Eastern Kentucky University

Abstract: One of the goals of the Sarbanes-Oxley Act is to discourage operators of listed companies from committing fraud because of the close scrutiny they are under by the government and investors. However, the act does not deter unscrupulous operators of microcap issues from committing fraud. Controversial practices in microcap fly largely under the radar of the media and the average investor, but have been prevalent long before the recently glamorized cases have hit the headlines.

The primary reason that we cannot overlook microcap issues is that they represent the majority of publicly held companies, as well as the majority of noncompliance with securities law. Except for a few cases of grand accounting frauds, most listed stock bubbles are caused by investor greed. However, most bubbles on penny stocks are caused by perpetrators' deliberately deceiving investors. Fraudsters of microcap stocks know that the SEC is severely understaffed and does not have sufficient resources to enforce the securities laws in every case, let alone smaller cases. Moreover, they often target senior citizens, low income, and neophyte investors who may be less likely to pursue the proper legal channels. Securities attorneys have little incentive to file class action lawsuits against the perpetrators of penny stock frauds because the cost of litigation may outrun any collectible award.

This paper presents three cases of Microcap companies whose practices were either controversial or outright fraudulent. Although no attempts have been made to prove their activities are illegal in an official capacity, these practices are at best disingenuous to the general public. Any company engaging in these activities should raise red flags for prudent investors.

Finally the author offers some insightful suggestions to prevent the recurrence of the controversial practices made by microcap companies.

What Year Is It?

After a recent war, Americans looked forward to a new found prosperity. A significant percentage of the population rushed into the stock market, looking to invest in small companies hoping to strike it rich either when the company hits the big time or when the next investor wants to buy at a ridiculously higher price. New companies were started with poorly conceived or no business plans, and without any real possibility of delivering on their promises. After one of the greatest expansions in U.S. history, spanning an unprecedented decade, huge sell-offs wiped out a majority of investor's fortunes. Public confidence in the financial markets plummeted as investors fled the stock market. A few years after this fall crash, Congress worked to identify the problem, and passed legislation aimed at providing closer scrutiny on listed companies by the government for investors.

1990s or 1920s? Between 1917 and 1929, an estimated 20 million Americans (20% of the population at the time) took advantage of the prosperity in the post-war I era. They rushed into the stock market gobbling up as many stocks as they could afford. Small investors easily

obtained credit from financial institutions that often offered to buy stocks at up to a 90% margin. Investors did not fear the dangers inherent in an uncontrolled market environment. The typical mentality was to get rich quick, selling their stocks to other gullible investors.

When the stock market crashed on October 29, 1929, the bulk of investors' fortunes were wiped out. Many investors could not meet the margin calls from banks and brokerage houses. This failure to meet the margin calls caused their financial institutions to incur significant losses. Moreover, banks also invested heavily in the markets; the crash significantly depleted their capital and caused the banks to be unable to fulfill their obligations to depositors. When depositors feared that their banks might become insolvent, they rushed to withdraw their money out of their banks. This domino effect created a catastrophic meltdown of the entire banking system, causing many financial institutions to fail. The crash and subsequent meltdown resulted in the Great Depression. Of the estimated $50 billion securities offered during this period, half became worthless. The public confidence in the financial markets plummeted.

Economists strongly believed that the government had to restore public confidence in the capital market before implementing any fiscal policies to restore the economy. When Franklin D. Roosevelt took the office in 1933, Congress started several hearings to identify the problems and search for the solutions. They identified that the main problem was that publicly held companies were not required to furnish financial information to the general public. Investors were often in the dark about the companies they chose to invest in. Congress then passed the Securities Act of 1933 and the Securities Exchange Act of 1934. Congress also established the Securities and Exchange Commission (SEC) to enforce these laws.

Our society has undergone tremendous changes since the crash of 1929. From new technologies, to new cultural boundaries, our world is very different from the Great Depression era. These changes have driven our economy to new and greater heights. Over the last two decades, the Dow Jones Industry Average has steadily risen from around 800 to the 11000 plus points set in Jan 2000; NASDAQ Average rose from 200 to 5,000 plus points by March 2000: this increase marks the longest bull market since the stock market's inception. The percentage of US households investing in equity markets has increased from 10% to more than 50% over this time period. An amazing variety of small investors are putting money into high beta stocks, hoping to discover the next Intel, Cisco Systems, Dell computers, or Microsoft. Like in the 1920s, people again flocked into Wall Street, hoping to get rich quick, and sell stocks to other gullible investors. With a voracious appetite for Internet stocks, a mentality very similar to the ebullient 1920s reemerged. Investors ignored the fundamentals. The valuation of the stock, especially the low quality, high beta stocks, reached alarming levels. Again, investors did not fear the dangers of bubbles that are inherent in the irrational market.

Although the securities industry has changed significantly since the establishment of the SEC, there persist common deceptions behind every stock fraud. The bear market that began in summer 2000, culminating with the huge sell-offs in September 2001, revealed that some high fliers were either cooking their books or were pumped and dumped by unscrupulous underwriters and analysts. The sheer size of these frauds has rattled Wall Street and diminished investor confidence. Investors lost as much as 70% of the market capitalization. This time we are talking about trillions not billions. The prolonged bear market that followed has made many investors hesitant of putting new money into the market, choosing instead to cash out altogether. Congress then passed the Sarbanes-Oxley Act of 2002 to strengthen the existing Securities Act of 1933 and Securities Exchange Act of 1934. The new Act may deter operators of listed companies from committing frauds because they are under close scrutiny by

the government and investors. It may not deter unscrupulous operators of microcap issues from committing frauds. Frauds and controversial practices in microcaps were prevalent long before the recent notorious cases but few were exposed by the media.

The primary reason that we cannot overlook microcap issues is that they represent the majority of publicly held companies but are the least compliant to securities laws. Except a few cases of large frauds, most bubbles in listed stocks are caused by investor greed. However, most penny stock bubbles are caused by deliberate deception of investors. At the peak of Internet fever, fraudsters brought everything with a dot com or a Chinese connection to the microcap markets. They peddle these rubbish issues to ingenuous investors because they know that the SEC was severely understaffed and does not have sufficient resources to enforce the securities laws in smaller cases. Moreover, fraudsters often target senior citizens, low income, and neophyte investors who may be less likely to pursue the proper legal channels. Securities' attorneys have little incentives to file class action lawsuits against the perpetrators of penny stock fraudsters because the cost of litigation may outrun the collectible award.

In 2004, SEC brought 490 civil cases against miscreants of publicly held companies. Only three cases involved listed companies. The majority of the remaining cases were against the fraudsters of microcap companies. These cases were probably just tips of an iceberg. Worse, civil judgments collected by SEC have been scant. Unscrupulous perpetrators frequently ignore the civil penalties and move on to other projects.

What are Microcap Companies?

Microcap companies are thinly capitalized issues that are typically not qualified for listing in NYSE or NASDAQ. These issues are quoted in either the Over-the-Counter Bulletin Board (OTCBB) or the Pink Sheets LLC. They are also referred to as penny stocks. A typical microcap issue has very few market makers. Moreover, trading in OTCBB and Pink Sheets are often sporadic and erratic. Thin trading of a stock ensures that a few market makers can easily control the market. The absence of rigorous listing requirements as well as the high possibility of price manipulation makes microcap issues easy ploys for unscrupulous individuals committing frauds. It is true that not all the issues in OTCBB are fraudulent. Some are listed stocks that no longer satisfy the minimum listing requirements in national exchanges. Some are well-known foreign companies that are not listed in national exchanges. Others are legitimate companies that cannot attract the interest of mainstream underwriters. However, the majority of companies in OTCBB or Pink Sheets are controversial or even fraudulent. They have few assets and no revenue or apparent future. To obscure these facts, these companies typically falsify or exaggerate their holdings; they announce possession of next-generation technologies or revolutionary products that they contend will generate huge sums of revenues in the near future. In reality, operators of these companies have no intention to develop their miracle products. Their primary interest is to pump and then dump their worthless stock to uninformed investors. The companies' stock prices will eventually plummet. Flush with cash, the swindlers move on. They restructure the now-defunct company with a new name and a new phantom product for a new group of naïve investors. Boosting the success of their schemes is the fact that that neither the OTCBB nor the Pink Sheets quotation service is a competitive market. Market makers in OTCBB or Pink Sheets often are small and obscure. They acquire OTCBB stocks at significant discounts and then artificially inflate the stock price by trading among themselves to establish the market. Once a market price has been established, their brokers cold call uniformed investors. The OTCBB and the Pink Sheets have created an environment that allows unscrupulous market makers and brokers to defraud investors.

COMMON MACHINATIONS TO DUPE INVESTORS

The Reverse Merger

In a mainstream merger deal, the acquiring company typically pays a premium of 30% to 50% over the fair market value of the acquired company's stock. However, many merger and acquisition activities for microcap companies occur in a very different manner. A shell corporation, without assets, revenues, or business activities, is publicly held and quoted in OTCBB or Pink Sheets, and acts as the acquiring company for a privately held company that has few assets or revenues. The shell corporation then issues the stock in exchange for the acquired companies' assets. The acquiring company then changes its name and ticker symbol.

A reverse merger allows a financially strapped privately held company or a start-up company to raise additional capital from the general public or venture capitalists without going through the registration process under Securities Act of 1933. However, it also offers many unscrupulous individuals an expedient way of making quick profits.

Therefore, many OTCBB or Pink sheet companies never dissolve even after they have lost all capital. They simply stay inactive as shell corporations. If the stock quotes on OTCBB, it just needs to file Form 10. If the stock quotes on Pink Sheet, the company simply does nothing. They wait and hope to resell their shells and bring other microcap companies to the public. Essentially, the defunct company revives from the ashes and absorbs a real corporation. In effect, it becomes a new entity, circumventing the registration process to become a publicly held company.

Unscrupulous Stock Promoters

The mainstream stock analyst steers away from microcap issues. Potential investors are unable to find reliable financial information on these companies because few are audited by reputable certified public accountants. Instead, these companies approach public relations firms to promote their stocks. These public relations firms frequently advertise themselves as independent, impartial stock analysts, sometimes failing to fully disclose that they routinely accept compensation from the profiled companies.

Some unfortunate investors receive nice-looking publications from these promoters through the mail. Other promotion schemes often take advantage of the explosive growth of the Internet and telecommunications. The public relations firms post literature of their profiled companies on their web sites and offer free newsletters, either by e-mail or by fax, to their potential victims. They may then follow up these tactics with a broker cold-call to the potential victims.

Naïve investors are unlikely to distinguish a public relations firm from a mainstream stock analyst. In most instances, if they do purchase the securities the price increases for a short time. After the fraudsters and stock promoters unload their shares, however, the prices drop substantially. When a naive investor attempts to sell his or her holdings, he or she discovers that very few buyers are interested.

While it is true that public relations firms are protected under the First Amendment, Section 17(b) of the Securities Act of 1933 specifies that stock promoters must disclose the amount of money or stock shares received from companies they profile. Promoters violate

Section 17(a) of the Securities Act of 1933 and Section 10(b) and Rule 10b-5 of the Securities Act of 1934, if they sell securities with manipulative or deceptive methods.

The Internet Message Boards

Internet chat rooms related to investment have mushroomed. Popular sites such as Silicon Investors, Yahoo, and Raging Bull attract thousands of investors daily. They also attract fraudsters. These deceitful individuals post as zealous investors exchanging ideas with other ingenuous investors. They may initiate a posting for microcap stocks, and then follow with hundreds of unsubstantiated messages describing favorable prospects and urging readers to buy or hold the stocks.

The "investors" may appear legitimate, because they flood the board with promising statements – either with messages under different aliases, or messages posted by their employees or relatives. They give the impression that they are simply investors sharing their opinions with the other message board participants, but they never disclose that they have acquired the stocks or options at a significant discount. After the price of the stock has been artificially enhanced, they dump their holdings while still urging readers to buy and hold the stock for long-term prosperity.

The Infomercial

In some cases, fraudsters host radio or TV infomercial shows to promote virtually worthless stocks without disclosing the compensations they have received from the companies they represent. They invite guests, masquerading as highly regarded Wall Street analysts, to give rosy predictions for the companies they represent. In fact, these guests are nothing more than paid promoters or accomplices. The television infomercial presentation of these miracle companies can thimblerig thousands of uninformed investors.

The Press Release

A company typically issues press release through prominent electronic news organizations such as Business Wire, Reuters, and Dow Jones News Wire. Mainstream corporations use press releases to announce earnings, major developments, and new products. They seldom distort facts because they are under the close scrutiny of analysts, fund managers, and lawyers. Microcap corporations, however, frequently use press releases to deliberately mislead or confuse the public. Thus, a "purchase order" may be nothing but a letter of intent. A "joint development agreement" with a well-known foreign company is nothing but a proposal. A revolutionary technology is nothing but a concept. A breakthrough development is nothing but an extravagant claim. A merger is nothing but a swapping of one worthless stock for another. Such press releases have one thing in common: They attempt to legitimize an illicit stock. Furthermore, in the Internet era, press releases spread through the cyberspace in microseconds. Therefore, an exaggerated press release often causes significant price swing to a thinly traded microcap issue.

The Private Placements

Mainstream companies occasionally raise additional capital through secondary public offerings. The issuers must file the registration statements and prospectus to the SEC. The procedures are almost identical to the primary public offering. Microcap companies frequently

raise the additional capital through private placements. They tend to issue the securities that circumventing the registration process. The most frequently chosen private placements are the Regulation D and the Regulation S.

The Regulation D Securities

The primary intent of the regulation D securities is to allow entrepreneurs to tap the venture capital market before the company is a full-grown publicly held corporation. The problem is that mainstream venture capitalists seldom invest in microcap start-ups that have no ability or intention to develop an emerging technology or miracle product. The microcap companies frequently turn to second-tier speculators, whose true intention is to make quick profits from the resell of these securities to uninformed investors through the OTCBB or Pink Sheets. Those speculators often acquire the restricted shares at a significant discount, as much as 99% discount from the bid price quoted by the market makers in the open market. They intend to pump the stocks up before they unload all their holdings, dumping them onto the unsuspecting legitimate investor. These issuers frequently choose Rule 504, limiting their total amount offering at $1,000,000, but avoiding the filing of any audited financial statements.

The Regulation S Securities

Regulation S, a special section of federal security law, permits a publicly held company to sell unregistered securities to foreign investors. Regulation S securities are often issued at a significant discount from the market price of regular common shares. The original intent was to allow companies to raise capital from the foreign markets without affecting the float of the securities in the domestic markets. The assumption was that the laws of the foreign jurisdiction regulating public offerings of securities would protect the foreign investors in that market. In microcap frauds, however, many of these foreign investors are U.S. citizens or corporations who establish shell corporations offshore. Many brokers then redistribute the shares back to the U.S., avoiding registration under the Securities Act of 1933.

Some purchasers of these unregistered securities immediately short sell the common shares and cover their short positions with the Regulation D and Regulation S securities later. Some of these securities carried conversion privileges that can convert the unregistered securities into the regular common shares at a fraction of the stock price at the time of conversion. In other words, if the stock price falls, holders of these unregistered securities will convert more shares. They are in a no-lose situation. Indeed, they have many incentives to short sell the stock to drag the stock price down. This practice is often called death spirals convertible securities.

Since February 10, 1998, SEC has tightened the screws to curb the abuses of Regulation S securities. Equity securities placed offshore by domestic issuers under Regulation S are classified as “restricted securities.” This means that the shareholders of Regulation S securities must file Form 144 to sell their unregistered securities. The distribution compliance period (the restricted period) for these domestic equity securities has been lengthened from 40 days to one year.

Creative Accounting

Fraudsters understand that revenues and earnings are main themes in the Wall Street. Rather than strive to generate revenues and control expenses, they frequently twist accounting

principles by deferring expenses and exaggerating revenues. Sometimes these companies cross-own shares among each other. They then classify shares from their affiliates as marketable securities. When the exchanged shares are sold, they will book as revenues. Therefore, they can inflate the GAAP earnings per shares. If they do not exchange shares among each other, the proceeds from issuing stocks will be in paid-in capital accounts. Sometimes they twist the rules for consolidation to pop up the revenues of shell corporations that are doing nothing but printing stock certificates.

Fraudsters constantly pushed the boundaries of the securities law, SEC regulations, and Generally Accepted Accounting Principles. They understand that the SEC does not have enough accountants and attorneys to audit tens of thousands filings from small companies. Unless they pushed to the limit, they are unlikely to be sued by the SEC or prosecuted by the Justice Department. It is questionable that Sarbanes-Oxley will deter these fraudsters from committing fraudulent acts.

The next section presents a few cases of Microcap companies implemented all or some the fraudulent tactics outlined above. Information is from the SEC Edgar Data Base and litigation releases.

Case I: Pro Net Link: A Grand Scale of Microcap Fraud

Pro Net Link (PNLK) was formed by Jean Pierre Collardeau on July 25, 1997. In September 1997, Prevention Productions, an inoperative pest control company acquired Pro Net Link through a reverse merger. Prevention Productions made a 30 to 1 reverse-split to reduce its outstanding shares to 249,500. It then issued 28,400,000 shares to PNLK shareholders and stock promoters. Prevention Production changed its name to Pro Net Link Corp. Mr. Collardeau and his wife received 16,500,000 shares. In October and November 1997, PNLK issued a total of 7,500,000 shares of common stock at $.02 each and 1,700,000 shares of common stock at $.10 each in private placements to two foreign companies and three foreign individuals pursuant to exemptions from registration pursuant to Rule 504 of Regulation D under the Securities Act of 1933. The stock started trading on OTCBB in October 1997.

In March 1998, the company paid $50,000 and stock to a web site stock promoter, Stockgenie.com, to write a very misleading report about the company's future. Stockgenie.com touted, "according to the company's business plan, over the next 12 months the company anticipates signing up approximately 40,000 subscribers at an average of $360 each which would generate revenues of 14.4 million dollars, which would be classified as subscriber revenue. Other revenue streams include, but are not limited to banner advertising revenue and fees for catalog listings, and others, which would produce gross revenues of approximately 21 million dollars in year one. For the first year the company estimates pre-tax income of approximately 16.1 million dollars, after-tax net income of approximately 8.7 million and an E.P.S. of 23 cents per share. In the second full year of operation the company anticipates approximately 47,500 new subscribers and 33,600 renewal subscribers for a total subscriber base of 81,100. This estimated subscriber revenue of approximately 29.2 million (81,100 subscribers x $360/annual subscription) combined with additional revenue streams is expected to bring in 42 million dollars. For the second year the company estimates pre-tax income of approximately 31.4 million dollars and after-tax net income of approximately 17 million dollars with an E.P.S. of 44 cents per share."

A company with seven employees was claiming that it was the world's largest business-

to-business web site for import/export. Yet, the web site was not functional until May 1998. Meanwhile many unscrupulous individuals started to post thousands of touting messages in Yahoo, Silicon Investor, and Raging Bull even though no mainstream analyst had ever issued a research report about the company. The stock was pumping up from $.78 to as high as $7.25 in May 1998. The irregular trading activities caught the attention of SEC. In June 1998, the SEC commenced an investigation and ordered PNLK to submit books, papers, documents, and other records concerning PNLK's business practices.

Instead of issuing securities under the registration process, the company continuously issued regulation D shares through private placements for capital. In September through October 1998, it issued 4,210,000 regulation D shares at $.20 each to three foreign companies for $842,000. In December 1998, Mr. Collardeau received 1,162,920 restricted shares from PNLK in exchange of a promissory note plus interest of $232,584. Mr. Micheline Baron, a venture capitalist received 1,056,150 restricted shares from PNLK in exchange a promissory note plus interest for $211,230. In February 1999, Pro Net Link issued 790,000 Regulation D shares at $.20 each to a foreign individual for $158,000. Between February and April 1999, Pro Net Link issued 5,000,000 Regulation D shares at $.20 each to three foreign individuals and one foreign company pursuant for $1,000,000. In June 1999, Pro Net Link issued 200,000 Regulation D shares to an individual at $2 each for $400,000. Investors in those private placements paid between 75% to 90% discount from the market price of OTCBB during that time. They have a strong incentive to dispose of their shares as early as possible.

Although the current SEC rule have lengthened the restricted period for unregistered securities to one year, it cannot preclude those shareholders to sell the restricted shares to investors in the foreign countries. Moreover, often shareholders of restricted shares frequently short sell the stock through Canadian brokers to lock in their profits.

The first annual report ended 6/30/1999 painted completely different picture from the pseudo-research report predicted by Stockgenie.com. Membership revenue was only $14,248 instead of $14.4 million. Advertising revenue was $0 instead of $21 million. Accumulated deficit was $3,866,205. The total outstanding shares ballooned to 50,868,570. Like many other microcap companies, PNLK continuously issued deep discount shares through private placements to stay as a going-concern entity. PNLK said that its executives received no compensations. However PNLK paid $7,500 to $10,000 a month to a consulting company, Zagoren-Zozzora Inc., a shell company owned and operated by PNLK's Chairman of the Board, Mr. Glenn Zagoren. Mr. Zagoren also received options to purchase 2,000,000 common shares at $.25 and $.33 per share. Mr. Zagoren constantly posted touting messages on Internet message boards, such as Yahoo, Silicon Investor, and Raging Bull. He flew to many countries to promote his business but has never actually negotiated any deals.

Mr. Collardeau stated that he and his wife would not sell their shares in the public market for one year. However, he did not tell the public that their shares were unregistered and could not be disposed during the restricted period of one year anyway. Furthermore, when the restricted period expired, he was limited to selling less than one percent of the total outstanding shares in a 90-day period. The lock-up agreement was further extended to June 23, 2000.

PNLK continued to issue Regulation D shares for operating capital. In October 1999, it issued 200,000 Regulation D shares at $2 to an individual for $400,000. In December 1999, it issued 400,000 shares under Regulation D at $2 each to one foreign individual for $800,000. In February 2000, it issued 360,000 shares under Regulation D at $2.50 each to a foreign

individual for $900,000. In March 2000, it issued 100,000 shares under Regulation D at $4 each to a foreign individual for $400,000.

Mr. Collardearu and his wife quietly sold 2,325,840 shares at $4 each to a private party for $9,127,520 in early 2000, even though he had announced that he would not sell any shares to public markets. Apparently, he used part of the proceeds to loan $1,500,000 to PNLK on August 8, 2000 and October 10, 2000. He agreed to loan PNLK up to $2 million during a period ending October 10, 2001. On October 10, 2000, PNLK sold 666,667 shares under Regulation D to an individual for $510,000.

In the second year of operation ended June 30, 2000, PNLK only produced $81,601 of revenue. The net loss was $3,959,243. The figures were far from $31.4 million revenue and $17 million profit touted by the paid promoter, Stockgenie.com. PNLK also touted that it had developed a novel flagship Internet TV program called, PNL-TV that could generate advertising revenue for $10,000 a minute. Internet TV is nothing new. All the major network and media companies have Internet TV in various forms. There is little room for a small player to compete against big players. As expected, PNLK has never generated any revenue from PNL-TV.

The financial condition of PNLK continued to deteriorate. The 10q statement of March 31, 2001, indicated that the nine-month revenue was only $14,459; the three-month revenue was only $70, while the nine-month loss was $2,655,523. The only source of cash inflow was $460,000 from Mr. Collardearu. Its ability to sustain itself as a going-concern was in serious doubt. On April 2, 2001, it tried to get a $5 million financing from Waveland LLC by offering warrants to purchase 1,465,416 shares at $0.1706 per share. On April 13, 2001, it sold the flagship Internet TV, PNL-TV to Mr. Zagoren. However, the financing agreement fell apart. On July 2, 2001, the company declared Chapter 7 bankruptcy.

On November 23, 2003, a federal grand jury indicted Mr. Collardearu and eight other conspirators for committing a $33 million securities fraud of bilking investors. Mr. Colardeau was arrested at the Newark Airport. Mr. Colardeau pleaded guilty on conspiracy to defraud investors on September 4, 2004. The former head of Stockgenie.com, the paid promoter for PNLK, pleaded guilty on engaging an elaborate scheme to defraud investors on January 5, 2005. Criminal charges against the fraudsters of penny stock frauds by the Justice Department are rare. This case was an exception rather than a norm because the size of fraud was too large. [1]

Case II: Hitsgalore.com: Preemptive Strikes Against Critics

Hitsgalore.com, Inc. was formed in July 1998 as an Internet company that provided a business-to-business Web portal and search engine. On March 19, 1999, the company entered a reverse merger with a bankrupt shell corporation, Systems Communications, Inc. to become a publicly traded OTCBB security. Systems Communications Inc. itself had also gone through various reverse mergers and name changes since 1987. It had engaged in the business of eyeglass distribution, residential building, pay-per-view television services, reselling telecommunication services, healthcare cost containment business, development, and sale and maintenance of medical management computer software. Most often, it was in the business of doing nothing.

In 1998, the company reported revenues of $17,779, net income of $1,007, and tangible assets of $1,984. It had virtually no significant business activities. On February 11, 1999, Hitsgalore announced the reverse-merger with Systems Communications. That day, the stock

was quoted on OTCBB at $1.05. When Hitsgalore completed the reverse-merger on March 19, 1999, it had issued 45,807,481 common shares. The stock was quoted at $2.83 per share, an astonishing market capitalization of $129 million. On April 9, 1999, the company got a new ticker symbol, HITT, and was quoted on OTCBB at $6.25. At the same time, many individuals appeared on the popular Internet chat rooms, Raging Bull and Silicon Investor, to promote the stock. The company's main business strategy was soliciting individuals to pay $99 to "sponsor" banner advertisements on the Histgalore web site. Sponsors were supposed to make money from a 25% referral fee. The company touted, "there is no limit on how many banners you can sponsor and that means no limit on your income for doing nothing more than being a sponsor! Why not become a proactive sponsor and make a killing!" However, very few banner ads were sponsored. That left only one option to the villains: cooking the revenues. The company then announced that its revenue in the first quarter of 1999 was near $500,000 and diluted EPS was two pennies. At first glance, the achievement was very impressive because most Internet companies were losing huge amount of money. However, more than 95% of the revenue was from one mysterious account, Life Foundation Trust, which the company gave 2,000,000 shares in exchange for a $10,000,000 contract. Due to investor enchantment with Internet stocks, the stock soared to as high as $20.69 on May 10, 1999. The market value of Hitsgalore.com had leaped from $129 million to $1 billion in less than two months. The operating capital was mainly from issuing 2,362,397 shares to related parties. Most of the shares were issued for exercise of warrants. The insiders were ready to cash in their windfall profit.

Numerous critics posted a variety of serious allegations about Hitsgalore.com and its officers. The anonymous posters called the corporation a "scam," a "flying turd," a "fraud"; they labeled its officers as "criminals," "crooks," "con men," "slime," and "scum" who had lied to the SEC and duped investors in a "classic pyramid scheme."

On May 11, Bloomberg News reported that that a principal shareholder and "founder" of Hitsgalore.com had had a run-in with the Federal Trade Commission ("FTC") over false and deceptive promises he had made to customers of an earlier Internet firm with which he was involved. The article said that the founder of Hitsgalore, Dorian Reed, and two co-defendants were ordered by a federal judge in Baltimore in April 1999 to pay $613,110 to 100 customers of Internet Business Broadcasting (IBB), an Internet advertising company that failed in 1998. The Federal Trade Commission accused Reed and IBB of sending junk e-mails, called "spam," touting a 100 percent annual return on investments of $5,000 to $7,500 in its Internet advertising banners. FTC described Reed as IBB's "principal telemarketer." He and the co-defendants were ordered not to make false and deceptive statements in the future. "We alleged they were lying to investors about how much money they could make," said FTC attorney Mona Sedky Spivack. The judgment against the three was entered after the defendants failed to appear for trial. The article said that Hitsgalore.com was founded in July; four months after the FTC sued Reed. The company was based a few blocks from IBB's former headquarters in Rancho Cucamonga, California. The article alleged that Hitsgalore didn't disclose the FTC's case against Reed in filings with the Securities and Exchange Commission. Instead, Hitsgalore.com said there were no suits or governmental investigations against any of its officers, directors, or employees. The stock plummeted more than 50% after the article.

The next day Los Angeles Times also ran an expose that apparently paraphrased from the Bloomberg's article. Lawyers began announcing plans to pursue class action lawsuits against Hitsgalore.com on behalf of angry shareholders. Moreover, the SEC initiated an investigation to determine whether Hitsgalore and the management had violated the federal securities laws in June 1999. The stock price continued to slide. The discussions in Silicon Investors and Raging Bull became very inflammatory. One poster stated that "these crooks

belong in jail!" and he even dared Hitsgalore.com to sue him.

Hitsgalore granted the poster's wish. It filed a $20 million suit against 100 John Does, claiming libel, tortuous interference, and a civil conspiracy to defame the plaintiff in order to unlawfully drive Hitsgalore.com's stock price "into a downward spiral" and thus to enable the defendants to profit by selling the common stock short. The company asked for compensation for the 75% drop in its stock price. It also sought removal of the allegedly defamatory postings from the message boards and an injunction against further postings of that nature. Contrary to Hitsgalore's contention, the price drop was not likely due to a conspiracy theory of libel. The fundamentals may explain most of the free fall of the stock price.

Although the language used by the critics may be harsh and tasteless, First Amendment obstacles offer very few possibilities for the plaintiff to succeed in this defamation case. Moreover, public figures must prove that the defendant's statements were false and that they were made intentionally or with reckless disregard of their falsity. Obviously, the lawsuit was an attempt to silence the critics. It may be also a tactic for management to divert the attention of shareholders away from its poor performance or questionable business practices. The management probably figured that John Doe had no resource to hire a counsel to defend himself. Therefore, Hitsgalore might win the judgment by default. It could ask the court issue an injunction to prohibit John Doe posting further.

When Hitsgalore filed its first 10K statement of 1999, it reported revenues of $7,395,959. However, 94.65% of revenues or $7,000,000 was from the same account, Life Foundation Trust. Life Foundation Trust defaulted on the $6,900,000 receivable on April 17, 2000. The default forced the company to report the bad debt loss on the 1999 income statement. The write-off caused the net loss of $2,624,461, negative working capital of $2,976,831, negative net worth of $2,343,405 and virtually no cash. The company could not survive for long at this rate.

On April 27, 2000, Hitsgalore filed a $500,000,000 libel suit against Bloomberg. The lawsuit alleged that Bloomberg and its reporter David Evans, through Bloomberg News, published a series of "Defamatory Articles" on May 11 and May 12, 1999, which contained certain false and defamatory statements regarding Hitsgalore. As a result of the publication of the articles, it alleged that the price of the Company's stock dropped about 53% in one day. Hitsgalore alleged that the article created the misleading impression that Hitsgalore.com had acted improperly in failing to disclose the FTC action against its founder. Hitsgalore alleged that the SEC imposed no duty to disclose the FTC action in the particular, and rather peculiar, factual circumstances of the case. Common sense tells that the lawsuit is almost groundless because Bloomberg report was based on the fact. On October 22, 2000, the Superior Court of the State of California granted Bloomberg and Evans a special motion to strike, brought pursuant to the "anti-SLAPP" statute and dismissed the suit. The Court also awarded the defendants attorney's fees in an amount of $327,622.

On June 9, 2000, SEC warned Hitsgalore that the Commission might file a civil injunctive action against the company and its former CEO, Steve Bradford. The recommended action involves alleged violations of Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5, promulgated thereunder, in connection with certain press releases issued by Hitsgalore prior to May 1999, regarding the Life Foundation Trust. Apparently, Hitsgalore agreed not to issue anymore preposterous press releases. SEC did not pursue further legal actions as a result.

In the 10K statement of 2000, Hitsgalore reported revenues of $162,959 and loss of

$4,826,241 for the year-ended December 31, 2000, cash of $25 as of December 31, 2000. The poor performance did not stop the company generously issuing 47,771,710 free shares to its insiders and 5,345,634 free shares to its employees and stock promoters during the year. Moreover, it issued 10,622,136 shares to settle short-term borrowings to related parties for $624,100 and 1,679,643 shares to related parties for $349,500, a steep discount from the market price at the time of issuance. The flood of these new shares caused a free fall of the stock price to as low as one penny by December 31, 2000.

On February 16, 2001, Hitsgalore announced that it had sold its dot com business for $20,000. The web site has been inoperative since the announcement. The company recorded the total sales as accounts receivable. However, the receivable had never been collected. On March 29, 2001, the company changed its name to Diamond Hitts Production. The company said that its new business strategy was "to seek and acquire profitable entertainment businesses and assets via acquisition, and liquidate, modify, extend or otherwise satisfy the indebtedness of the company." However, the long-phrase simply implied that the company was a shell corporation doing nothing but waiting for an opportunity for a reverse-merger. In other words, it is looking for an opportunity to deceive a new group of naïve investors.

The 10q statements of the first, second and third quarter of 2001 did not report any revenues but plenty of expenses. As of September 30, 2001, it reported no assets, no revenues, no business activities, nine-month loss of $3,150,122 and liabilities to related parties of $4,494,730. Like many penny stocks, the company did not file for Chapter 7, it simply became inoperative. The stock then was out of circulation.

On November 29, 2001, SEC filed a civil suit against the former present of Hitsgalore.com, Stephen J. Bradford and the administrator of Life Foundation Trust, Jeanette B. Wilcher, alleging them issuing false and misleading press releases, and committing securities fraud for bilking over one million dollars form investors On October 23, 2003, a federal grand jury indicted Ms. Wilcher for intentionally defrauding investors out of more than $3 million dollars in connection with a high yield investment scheme and charging her with eight counts of wire fraud and six counts of money laundering. [2]

Case III: Todotrade.com: Pump-and-dump at its best

Consider the case of 2Dotrade.com (TDOT). A company formed from a reverse-merger on June 17, 2001. According to the SEC filing, the company had no revenues and $26 of assets on the date of inception. In July and August 2001, it issued at least six false press releases stating that it had secured several import/export trading contracts of $250 to $300 million in some third world countries. In fact, they were worthless. The perpetrators then blasted faxes and spam e-mails, creating artificial demand for the company's shares. On Sunday August 5, 2001, an unscrupulous individual, using over a hundred aliases that he had created seven months earlier, sent over 1,000 touting messages on Raging Bull message boards. The person claimed that he had bought 2,000 to 3,000 shares of TDOT, a company with $.65 PE, hundred millions of revenues, and asked the readers to do the same. He did not send more than eight messages under each alias to disguise himself as many different ordinary investors. Meanwhile, an active poster on the TDOT message board continuously promoted the rosy outlook of the company. In fact, the company had failed to file a 10q statement to confirm all those positive financial figures. The touting messages had caused a surge of volume and the stock jumped from $.30 to $.85 per shares on August 6, 2001. SEC alleged that several of the defendants dumped millions of shares into the market, primarily through offshore nominee brokerage accounts, collectively realizing approximately $1.6 million of unlawful trading profits.

The surge was short-lived. By August 14, 2001, the stock fell to $.33 per share. When the company filed the 10q statement of the second quarter of 2001 on 9/4/2001, it showed no assets, no revenues, expenses, and net loss of $4,449. The stock fell to $.09 by September 26, 2001. On October 31, 2001, at the height of the anthrax scare, the perpetrators claimed that 2DoTrade was testing an anti-anthrax compound called 'ARHQQ", capable of eradicating many types of bacteria, including anthrax, at a hospital and a university in the United Kingdom for distribution in the United States but no anthrax testing ever occurred. The fraudulent anthrax claims, which involved two false and misleading press releases, blast faxes, and spam e-mails, created artificial demand for 2DoTrade shares. The share price spiked from $.10 to as high as $.48 in a few days. SEC alleged that the defendants dumped over 700,000 2DoTrade shares into the market, again, primarily through offshore nominee brokerage accounts, for which they collectively received approximately $240,000 of unlawful trading profits. SEC immediately suspended trading in shares of TDOT for 10 days on November 6, 2001. OTCBB announced delisting TDOT on November 20, 2001. On September 30, 2003, SEC filed a suit against the operators and their unscrupulous brokers of TDOT. [3]

SUMMARY AND CONCLUSIONS

The author presented three case studies of penny stock frauds, showing how these companies were able to operate indefinitely and continuously shift business focuses with no intentions of making profits. Their only objective was to sell worthless securities to uninformed investors. The tactics used by these companies are not uncommon. Although the fraudsters of these companies were either sued by SEC or prosecuted by the Justice Department, they represent a minute portion of the insidious investments. What can we do to prevent the recurrence of the controversial practices made by many microcap stocks described in the previous sections?

First, strengthen the sponsoring requirements for microcap issues. The SEC and National Association of Securities Dealers (NASD) should establish a minimum capital requirement. A shell corporation with no assets, no capital, no employees, and no intention of doing meaningful business activities should not be allowed to register as a publicly held company. In major exchanges, when a listed company files chapter 11 or Chapter 13 bankruptcy, it is removed from the exchange immediately. NASD should enforce the same standard for the OTCBB and Pink Sheet issues. This requirement will prevent miscreants from orchestrating reverse mergers to resurrect defunct companies from ashes to defraud uninformed investors.

Second, consider a reverse merger as a new public offering instead of a recapitalization. The parties involved will have to file a registration statement, audited by a CPA, and prospectus with the SEC. The former controlling shareholders as well as the underwriters should be de facto insiders for at least one year and cannot sell their shares unless they file statement 144 to the SEC. This change will discourage the former controlling shareholders and underwriters from manipulating the stock price immediately after a reverse merger for their own gain.

Third, increase the compensatory and punitive penalties for fraudulent activities. Although the SEC and federal courts have imposed civil and sometimes criminal penalties against many stock fraudsters, more than 50% of those penalties remain uncollected. Many defendants claim that they are insolvent. SEC has no choice but to seize whatever remaining assets these fraudsters own and waive or reduce the penalties. It is conceivable that some fraudsters hide their illicit profits but claim that they are insolvent, requesting a waiver of penalties and restitution. They then move on to start a new swindling scheme. Unless the

courts are willing to punish these willful violators with long imprisonment besides heavy fines, the fraudsters will not be deterred.

Fourth, outlaw regulation S securities. These securities post potential threats to uninformed investors. Although a company that issues regulation S securities must file an 8-K report with SEC in 15 days, this action does not preclude the buyers of those securities from shorting the common shares and then covering the short position with the converted common shares from regulation S securities later. As long as the buyers hold the regulation S securities more than 40 days, it is perfectly legal. The miscreants and their accomplices can easily establish shell corporations offshore to defraud the gullible investor. If the government prohibits the regulation S securities, all these abuses stop.

Finally, investors must make informed investment decisions. They should not make decisions based on unsolicited cold-calls, Internet message boards, junk mails, or a recommendation from a web site. They need to thoroughly investigate every small company before they want to risk their savings. Stay away from companies that do not file audited financial statements to SEC regularly. Be sure that these companies are audited by reputable CPA firms. Be able to analyze the financial statements. Check the registration statements through SEC's EDGAR database. Verify every single claim may by the company. Contact major customers or suppliers of the company to validate whether the contracts or purchase orders exist. Understand the technology and product that the company claims to own. Visit the company's office or production facilities to see whether it physically exists.

Many legitimate entrepreneurs strive to develop next generation technologies or revolutionary products and services. If they succeed, their investors will be handsomely rewarded, and the general public would reap the benefits. At the same time, many unscrupulous individuals also create investment schemes to defraud the gullible investors. If they succeed, these investors will wake up one day and discover that their life savings have evaporated. The investor must ponder every investment opportunity and ascertain its legitimacy. The Internet provides an excellent tool for investors. However, the Internet is a double-edged sword – a source of information and a source of fraud. An investor must be vigilant for any false information passed through the Internet and other channels, or they risk becoming prey to another insidious investment.

ENDNOTES

[1] US Department of Justice, Newark, press releases: November 23, 2003, September 4, 2004 and January 5, 2005.

[2] SEC v. Hitsgalore.com Inc., Stephen J. Bradford, Life Foundation Trust, and Jeanette B. Wilcher, Civil Action No. 01-CV-1133

[3] SEC v. 2dotrade, Inc., George Russell Taylor, et al., October 2, 2003, Civil Action No. 3:03-CV-2247

THE MORALS CLAUSE: A CASE STUDY IN ETHICAL BEHAVIOR

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Abstract: In recent years, many businesses and accounting firms have redefined their commitments to "global codes of conduct" and the importance of maintaining the highest sense of ethical behavior. However, a firm's reputation is built on the integrity of *each* of its employees, and as the Enron, WorldCom, and Andersen cases have demonstrated, a lapse in judgment by just a few people can have dire consequences. The focal point of this case is the moral obligation one has to his or her own employer. In fact, this obligation has become so important that some firms require their employees to sign an employment contract which contains, for lack of a better word, a morals clause. Most ethics cases focus on business improprieties, whereas this case addresses interpersonal working relationships by illustrating the complexities of determining when a fellow employee's conduct is considered to be unacceptable and whether one has a contractual obligation to report a perceived misbehavior.

XYZ Inc. requires all employees to sign a "morals clause" which provides that employment can be terminated for behavior which may injure the firm's image or reputation. Indiscretion or unethical behavior could cause embarrassment for the company, especially when an employee is convicted of an offense or engages in acts of "moral turpitude." XYZ's employment contract contains two parts: a *termination for cause* section and a *reporting of a problem* section.

Termination for Cause: If employment is terminated by the firm for "cause," all payments and benefits to which the employee otherwise would be entitled under this agreement shall immediately cease. For purposes of this agreement, the term "cause" shall mean:

1. The employee is convicted of a felony or any crime involving moral turpitude; or,

2. A reasonable determination by the firm, after giving the employee notice and an opportunity to be heard, that (a) the employee has willfully and continuously failed to perform substantially his or her duties as contemplated by the firm (other than such failure resulting from incapacity due to physical or mental illness), after a written demand for corrected performance is delivered to the employee by the firm which specifically identifies the manners in which the firm believes the employee has not substantially performed his or her duties or (b) the employee has engaged in gross neglect or gross misconduct, resulting in material harm to the firm.

Reporting of a Problem: If you become aware of a potential problem that could be harmful to the firm in any way, you have an obligation to raise the concern.

1. You do not need to prove it, you could make matters worse. There are special rules surrounding the gathering of evidence for use particularly in criminal cases. Attempts to gather evidence by people who are unfamiliar with these rules can inadvertently destroy the case.

2. Pass on any reasonable suspicion to someone in authority. This is usually your manager or office partner or the firm's "anonymous" phone contact. If possible, make a note of key details, such as what caused your suspicion, when things happened and who was involved. Do not report your suspicions to someone who

does not have proper authority.

3. If you use the anonymous contact number, you will not be asked to prove your concerns, so don't wait for proof. Remember, the sooner the problem is raised and looked into, the sooner any wrongdoing can be stopped and the sooner you and others can be reassured things are in order.[1]

Current Situation

Mary has been working as an auditor for XYZ for almost two years. She is currently on an out-of-town inventory assignment with Bob, the senior running the job. The two of them have been on this job for several days and will probably be there at least two more days because of complications with the client's records and inventory miscounts.

It's a Thursday and after another long and frustrating day's work, Mary and Bob decide to call it a day and go out to eat. Bob takes his car and drives them across town to a local restaurant and pub that was highly recommended by their client. During and after dinner, Mary believes Bob has more than just a "few" drinks and seems noticeably slower in his speech and reactions. When Mary hints that perhaps she should drive, Bob shrugs off the suggestion and they get up to leave.

As they go to the car, Mary believes that Bob is now clearly intoxicated by the way he is walking and his slurred speech. When Mary demands that he give her the car keys, Bob takes offense and starts yelling that she should just mind her own business and get in the car. Several by-standers observe their exchange, including two managers employed by their client.

Rather than confront Bob in public, Mary reluctantly gets in the car deeply concerned about whether Bob will be able to drive safely back to the hotel where they are staying (in separate rooms). As they get in the car and start to buckle their seat belts, Bob makes a totally unexpected move by putting his arms around Mary. Mary uses all her strength to push Bob away and screams "What do you think you're doing? Don't you ever do that again!" Bob's face turns red and he shouts back at Mary "Then why don't you just get out of the car and get your own ride!" Mary indeed gets out of the car, walks back into the pub, and calls for a cab as Bob drives off, tires screeching.

Required: Answer the following questions.

1. Do you consider Bob's reported behavior ethical?
2. Is Bob's behavior a cause for termination per the employment contract? Is it a problem that should be reported?
3. What actions, if any, do you recommend that Mary should take?
4. Reconsider questions one through three in the following independent circumstances. Explain your reasoning for any changes in your responses.

Alternative Scenario 1: As far as Mary knows, Bob has never acted like this before. Mary also is aware that Bob is obviously under extreme pressure, not only from the audit manager and partner to get the job done quickly, but also from his wife because of the long hours he has been working. Although Mary hasn't known Bob for very long, she really likes working with him and is considering whether this was just an isolated incident and if poor Bob just had a momentary lapse of appropriate behavior.

Alternative Scenario 2: Mary has heard that Bob has a reputation for having more than just a few drinks after work, but the partners don't mind because Bob is the office workhorse, always dependable, and the only senior who always volunteers to go on any out-of-town assignments. Bob wants to make partner someday and, according to office gossip, he is on the fast-track. Mary is worried that if she voices her concerns about Bob, she will be perceived simply as a troublemaker and the situation will become a "he-said/she-said" disagreement. Mary is also afraid that she will be considered too soft for dealing with the harsh realities of the work world which, in turn, may put her career in jeopardy.

Alternative Scenario 3: Lately, Bob has been the focus of "water-cooler" discussion. When Mary gets back to her hotel room, she gets on the phone with Sally, a co-worker, to vent her frustration. As soon as Mary comes to a pause, Sally interjects with a claim she once heard of another very similar situation about Bob. Mary now furiously asserts to Sally "and on top of dealing with a drunk, I had to physically shove away his uninvited sexual advances, and was practically thrown out of the car all the way across town!"

Alternative Scenario 4: Now, assume that Bob is the client's controller rather than an employee of the CPA firm. Mary first met Bob on this engagement and he suggested that they go to dinner to relax after a long day of work. No other employees of the client or the CPA firm were present. How should Mary handle this behavior from a client?

Postscript: On the following Monday, Bob's first day back in the office since completing the audit field work with Mary, George, the office managing partner, corners Bob. "We need to talk, now," bellows George. Bob follows George into the conference room, puzzled by George's behavior. George closes the door and tells Bob that Mary has contacted an attorney about filing sexual harassment charges. According to Bob, Mary's observations were simply her biased perceptions. He says that he merely had a couple of drinks with his meal. Bob has frequently joined several of his senior managers and occasionally even a partner or two for a Friday night dinner after a very long work week. Her claim that he was walking funny was due to leg cramps caused by sitting for over 12 hours a day. He said that his speech was not slurred, but that he had to raise his voice because the parking lot was loud and Mary probably did not hear him very well since she was standing on the other side of the car. Bob also says that while in the car, he merely leaned over to try and apologize to Mary when she totally "overreacted." Bob believes that Mary is vindictive because he did not give her a favorable review the previous week. According to Bob, Mary is generally not known as being a hard worker and does not like being told what to do. When Bob finds out about Mary's accusations, he seriously considers asking the partners to either fire her or make sure she never works on one of his assignments again.

Required: Does Bob's explanation change your advice to Mary in any of the scenarios above?

CASE LEARNING OBJECTIVES AND IMPLEMENTATION GUIDANCE

Overview of Case

This case focuses on the moral obligation one has to his or her employer. In recent years, many businesses have developed "global codes of conduct" prescribing a standard of behavior for which all employees are accountable. This case allows students to discuss the ramifications of codes of conduct and the extent to which they are responsible for monitoring another's behavior. Most ethics cases focuses on business improprieties, whereas this case

addresses interpersonal working relationships. Many new graduates are not prepared for these issues upon graduation.

Learning Objectives

The case permits an instructor to emphasize some or all of the following objectives, depending on the amount of time available and the instructor's goals. First, the case can be used to introduce students to different schools of ethical thought. The alternative scenarios introduce additional factors which may affect students' initial recommendations. These alternatives are similar to the complexities encountered in the "real-world."

Second, the case provides an opportunity for students to learn about codes of professional conduct and the responsibilities such codes place on employees. Students must identify unethical behavior, their responsibilities to report the unethical behavior of others, and the consequences of their actions. The case encourages a discussion of responsibilities both on and off the job. Students are typically not aware that when they travel on an out-of-town assignment, they are always legally "on-the-job."

Third, the case demonstrates the steps in the process of ethical decision making and allows students to apply them to a real-world situation. In this case, as in real life, students must consider the role of mitigating factors in choosing an appropriate action. This exercise helps students see how individuals often view the same situation very differently.

Implementation Guidance

The authors have used this case in income tax and auditing classes with one hundred and five junior, senior, and graduate students. Students read the case and then discussed the alternative scenarios. The case can be used in a short 50 minute class period. We recommend that after the case is read, each of the alternatives be considered one at a time. The instructor can distribute and discuss a new scenario separately in order to focus on the new details: Bob's extreme pressure at work, his after-hours drinking habits, the partners' positive perception of Bob's work, and Bob's reputation.

The instructor can introduce the requirements of a code of professional conduct with the original case material or later during the class discussion. Instructors may want to emphasize codes of conduct by sharing examples from major corporations.

If desired, students can complete the survey contained in the Appendix so that the instructor can determine the overall class opinion and share the results with the students.

Instructors could also consider inviting business executives to lead the discussion and provide guidance as to their interpretations of a code of conduct.

Student Feedback

Three-fourths of the students stated that the case increased their awareness of ethical dilemmas that they may encounter on-the-job. A large majority, 78 percent, said that completing the case gave them a greater understanding of codes of conduct. Eighty percent of the students agreed that the case helped them understand the steps in ethical decision making. Table 1 summarizes the student responses.

TABLE 1
STUDENT FEEDBACK

	Strongly Agree 1	2	Agree 3	4	Strongly Disagree 5
This case increased my understanding of ethical dilemmas that may be encountered in accounting practice.	21.5%	16.9%	36.9%	24.6%	0%
This case increased my awareness of firm codes of conduct.	27.7	24.6	24.6	21.5	1.5
This case increased my understanding of different schools of ethical thought.	24.6	23.1	27.7	20.0	4.6

Concluding Comments

This case introduces students to interpersonal ethical dilemmas and codes of conduct which they will likely encounter in practice. Due to peer pressure, students are typically reluctant to report misbehavior of others. As employees, students must feel confident that they can report unethical behavior without fear of retribution. Students may also need to broaden their concepts of unethical behavior. Many students will have witnessed drinking and driving and not considered the potential consequences of this behavior. Students need to be aware that when traveling on business, employers can be held liable for damages caused by an employee's driving under the influence of alcohol or other controlled substances.

The alternative scenarios allow students to weigh the importance of different explanations on their recommendations. Students see that ethical cases are usually not easily resolved and their decisions often have uncomfortable consequences.

TEACHING NOTES

Since there are no clear-cut answers to the questions posed by the case, only opinions, these Teaching Notes are organized by objective and provide the instructor with additional information that may be used as part of the class discussion.

The first objective of the case is for students to understand popular views of ethical behavior. Any discussion on ethical behavior is better served if students are first encouraged to ask themselves "what exactly is ethics?" Replies may range from "whatever your feelings tell you is right" to "what your religious beliefs tell you is acceptable" "to whatever action is best for the common good." The teacher can present overheads or slides with various definitions and examples of ethics and morals taken from a variety of sources (e.g., a Google search of "ethics in accounting" will bring up over 10 million hits). These theories range from Utilitarianism (promoting the best long-term interest of the group over the individual), to Kant's Imperative (taking the action that one believes everyone should take in the circumstances regardless of the consequences of the single action). Table 2 describes three primary schools of ethics.

TABLE 2
SCHOOLS OF ETHICS

School	Key Principles	Philosophers
Virtue Ethics	I aspire to a set of virtues. I avoid a set of vices. I am a good person if I live by my virtues.	Aristotle (384-322 B.C.) Alasdair MacIntyre (1929 to present)
Consequentialist Ethics	My behavior should bring as much goodness as possible into the world, making the most people happy.	David Hume (1711-1776) Jeremy Bentham (1748-1832) John Stuart Mill (1806-1873)
Deontological Ethics	I arrive at ethical principles through reason, which is universal among all humanity. I have a duty to others based on my ethical principles.	Immanuel Kant (1724-1804)

Source: Dobrin, A. 2002. *Ethics for Everyone*. John Wiley and Sons, New York, New York.

Most professions have adopted deontological ethics by defining standards for professional conduct. These principles are based on a duty to the profession, client, and public. By specifically defining ethical behavior, the profession seeks to avoid differing interpretations of "what is right." At this point, the instructor can describe guidelines for ethical conduct in the professional literature and firm policies. For example, CPAs need to comply with the AICPA's Code of Professional Conduct, particularly with Article I – Responsibilities (i.e., In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their responsibilities). Bob's actions might be considered a violation of the Code because he was not exercising sensitive professional and moral judgment. Bob may also violate *Code of Professional Conduct* Rule 501 pertaining to acts discreditable to the profession. CPAs have been found to violate this rule by committing a felony. Forty-four states and the District of Columbia have laws making driving under the influence of alcohol a felony, particularly if it is a repeated offense.[2]

This discussion provides a basis for examining specific codes of conduct adopted by accounting firms (the second objective). KPMG's Global Code of Conduct emphasizes their commitment to provide a workplace that is free from discrimination and harassment. It also states that "people who manage others should be a positive role model by showing what it means to act with integrity" (KPMG 2005). Deloitte proclaims nine ethical principles, including "respect and fair treatment," interpreted as "We treat all our colleagues with respect, courtesy and fairness" (Deloitte 2005). Ernst and Young's Global Code of Conduct specifically addresses whistleblowing: "We understand that deviation from and violations of the Global Code of Conduct are unacceptable and that we should be able to raise them, without fear of retaliation, to appropriate colleagues or to the relevant Ethics Hotline." The code continues to state that the firm does not permit discrimination or retaliation of any kind for good faith reports of illegal or unethical behavior (Ernst and Young 2004). PricewaterhouseCoopers' Code of Conduct contains similar provisions, stating "Those who violate the Code or other PwC policies and procedures will be subject to disciplinary action, up to and including dismissal. Disciplinary measures will also apply to anyone who directs or approves infractions or has knowledge of them and does not promptly move to correct them" (PricewaterhouseCoopers 2004).

KPMG recently released the results of a survey on corporate integrity. They found that companies with ethics programs were more likely to have reduced employee misconduct, greater employee reporting of misconduct, and greater confidence in how the employer would respond to alleged unethical behavior. However, many employees do not believe that whistleblowing would be productive in their organization. One-third of the approximately 4,000 respondents stated that they were unsure whether, when confronted with evidence of unethical behavior, their employer would correct the problem (KPMG 2006).

While some behaviors are clearly unethical (e.g., theft), students' opinions regarding the morality of various actions will differ. One behavior often overlooked by students is drinking while driving. Students may argue that their actions outside of work are not subject to scrutiny by their employer. Legal precedents have defined the scope of "work" broadly, however. According to the doctrine of *respondeat superior*, employers are liable for actions of their employees performed within the scope of employment. The courts have consistently ruled that employees are acting within the scope of their employment while they are traveling on business, even during off-duty hours (Roszkowski and Roszkowski 2005). In *Edgewater Motels, Inc. v. Gatzke* (277 N.W. 2d 11, Minn. 1979) the Supreme Court of Minnesota found the employer Walgreen Company liable for the actions of an employee who negligently started a hotel fire while smoking a cigarette. The employee, Gatzke, was a district manager who was working out-of-town supervising the opening of a new store. The fire began after Gatzke completed a

17-hour day and was in his hotel room. This case has significant implications for auditors traveling to client locations. If an accounting firm can be held liable for damages resulting from an accident where an employee is driving under the influence of alcohol, then the partners of that firm have a right to know if an employee is drinking and driving in the scope of employment.

The third objective focuses on the process of ethical decision making. Most ethics guides describe the steps in ethical decision-making as similar to the following (e.g., AICPA 2002, Whittington and Pany 2006):

1. Establish the facts. Here students also need to consider mitigating factors affecting Bob's behavior, such as home pressures, or the possibility that Mary is lying.
2. Identify the alternatives. In scenarios one through three, Mary could do nothing, tell someone within the firm, confront Bob, or talk to people not associated with the firm. In the fourth scenario, she could also discuss the situation with a representative of the client. If she decides to discuss the situation with someone in the firm, Mary needs to determine who is most appropriate. Many firms have written policies on sexual harassment identifying an ombudsman or other individual trained to handle such complaints. If Mary decides to confront Bob, what should she say? Mary may also consider calling an employer ethics hotline.
3. Evaluate the potential consequences of each alternative. Students can share ideas as the likely outcomes under the different courses of actions.
4. Consider your personal values. In this step, students have the opportunity to determine whether Bob's conduct (or Mary's, if she is exaggerating as in the postscript) violates their personal ethical standards. By discussing the case, students learn that there are no clear answers to many complex ethical dilemmas.
5. Obtain feedback from others. Before talking with anyone within the firm, Mary should consult professional guidelines and firm policies to determine the appropriate action. Mary should determine whether her firm has a morals clause and, if so, her responsibilities under that clause.
6. Decide on a course of action.

When having difficulty deciding on an appropriate action, the codes of conducts provide questions to consider, such as:

(1) Would you be embarrassed if others knew you took this course of action?
(2) How would it look in the newspapers?
(3) Will it reflect negatively on you or the firm?
(4) Can you sleep at night? (PricewaterhouseCoopers 2004).

Ernst and Young suggests the following questions: "Would my actions damage the reputation of Ernst and Young? Am I treating others the way I expect others to treat me?" (Ernst and Young 2004). Since some of the client's employees witnessed Bob's reported behavior, it is possible that these individuals' regard for the accounting firm has diminished. In this case the manager in charge of the audit may need to know about the incident to conduct damage-control.

The scenario in which Bob is the client can promote additional discussion. Most, if not all, accounting firms would prefer that Mary discuss the situation first with her supervisor or someone else within the firm before going to the client. In fact, some firms might consider Mary's going first to the client with her complaint grounds for termination.

The postscript presents Bob's depiction of the events, which is quite different from Mary's. The case demonstrates that there are often two sides to ethical cases and points to the need for an unbiased hearing. Table 3 describes our students' responses to the survey contained in the Appendix.

This case provides a rich background for exploring numerous topics relevant to professionals. Students graduate with a focus on the importance of technical knowledge in their careers. In reality, people change jobs more often due to interpersonal issues rather than a lack of technical skills.

TABLE 3
SUMMARY OF STUDENT RESPONSES

	Scenario 1	Scenario 2	Scenario 3	Scenario 4
Do nothing	1.4%	0.0%	0.0%	1.3%
Discuss the situation with only Bob	68.6	26.5	7.8	47.5
Discuss the situation with a superior in her office (or the client in scenario 4)	17.1	42.7	52.0	8.8
Contact the firm ethics hotline	7.1	26.5	23.4	26.3
Other	5.7	4.4	16.9	16.3

ENDNOTES

[1] Examples of employment contracts are available at www.onecle.com. The termination for cause provision is found at http://contracts.onecle.com/qwest/allen.emp.2004.08.19.shtml) and the reporting of problems (whistle blowing) at http://www.pcaw.co.uk/help_indiv/index.html

[2] For details, see www.madd.org/laws/Law.

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APPENDIX

1. This case increased my understanding of ethical dilemmas that may be encountered in accounting practice.

1	2	3	4	5
Strongly Agree		Agree		Strongly Disagree

2. This case increased my awareness of firm codes of conduct.

1	2	3	4	5
Strongly Agree		Agree		Strongly Disagree

3. This case increased my understanding of the steps in making ethical decisions.

1	2	3	4	5
Strongly Agree		Agree		Strongly Disagree

Indicate your level of agreement with the following statements:

4. In the first scenario, I believe that Mary should:

_______ Do nothing.

_______ Discuss the situation with only Bob.

_______ Discuss the situation with a superior in her office.

_______ Contact the firm ethics hotline.

________ Other (describe)____

5. In the second scenario, I believe that Mary should:

_______ Do nothing.

_______ Discuss the situation with only Bob.

_______ Discuss the situation with a superior in her office.

_______ Contact the firm ethics hotline.

________ Other (describe)____

6. In the third scenario, I believe that Mary should:

_______ Do nothing.

_______ Discuss the situation with only Bob.

_______ Discuss the situation with a superior in her office.

_______ Contact the firm ethics hotline.

________ Other (describe)____

7. In the last scenario, I believe that Mary should:

_______ Do nothing.

_______ Discuss the situation with a superior in her office.

_______ Contact the firm ethics hotline.

_______ Discuss the situation with Bob's supervisor (the client).

_______ Other (describe)____

TAXATION OF LIMITED LIABILITY COMPANIES IN THE UNITED STATES AND SELECTED COUNTRIES INTERNATIONALLY

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Abstract: As there is no one basic source for information on the taxation of Limited Liability Companies in the United States and Internationally, this paper will address these issues for the United States, Germany, Japan, Canada, Puerto Rico, United Kingdom, Ireland, and the European Union.

INTRODUCTION

A limited liability company (LLC) is an unincorporated business organization that combines the tax advantages and flexibility of partnerships with the limited liability features of corporations. Basically, an LLC is a limited partnership (LP) without a general partner. LLCs are owned by members, similar to stockholders in a corporation (either C-Corp or S-Corp).

Some readers might think that the LLC concept is fairly new — in the United States, yes; but in 1892 the first LLC was established in Germany, under a German company law referred to as *Gesellschaft mit heschrankter Haftung*. This basically started the origins of the Limited Liability Company. In the United States, the various states are where much of the legislation on formation, fees, and other items are regulated. As recently as 1990, only two states allowed the LLC form of organization — Wyoming (1977) and Florida (1982). The growth of LLCs has increased from only 2 states in 1989 to all 50 states and the District of Columbia as of 1997.

To simplify, and clarify the law, and to create uniform statutes throughout the U.S., the Uniform Limited Liability Company Act (ULLCA) was established in 1996. Though not a state law nor a federal law, this Act is the most "widely referred to and adopted document on LLCs, as it is the most 'comprehensive' document available on the subject."[1] The 1996 ULLCA was formally adopted by a few states, as of 2006. In March, 2003, the National Conference of Commissioners on Uniform State Laws (NCCUSL) proposed a new version of the ULLCA. The most recent draft proposal was in February, 2006, and as David S. Walker of the Drake University Law School and the NCCUSL stated, "The Drafting Committee's charge is thus not only to re-visit ULLCA but to consider whatever instruction can be found in each state LLC statute. The Committee's goal is to draft a new act that will incorporate the learning of the past 25 years and thereby maximize the chances of uniformity."[2]

LLCs IN THE UNITED STATES

In the various states, the legal matter of taxation of LLCs has been subrogated to the Federal Government, through the Check-the-box Regulations (CTBR). The Internal Revenue Service (IRS) Form 8832 is the form by which LLCs convey to the Federal Government *how* this entity (LLC) wishes to be taxed. (In most states, if an LLC completes the 8832 and sends it to Philadelphia, PA, the states will hold that that election will be the enforcing factor for taxation in the various states.) Some entities are exempt from the CTBR, as these are *Per Se* companies. These include, "any entity organized as a corporation under state law, organizations wholly owned by a state, certain banking organizations, organizations that are taxable as corporations other than under Section 7701(a)(3) of the IRC, and a vast list of certain organizations formed

under the laws of various foreign rules."[3] These entities will be discussed further in the international sections of this paper.

Since 1989, the Federal Government has treated these LLCs as partnerships and taxed these entities as such. In 1996, Treasury Reg. 301.7701 was instituted and outlined the procedure for the LLCs to use when completing Form 8832. In these regulations, an LLC may be taxed as a corporation, sole proprietorship, and more recently, as a Subchapter S corporation. Proposed Treasury Regulation Section 1.402(a)-2(h)(2) of December 29, 1994, deals with the situation of self-employment taxes for LLC members. These regulations were withdrawn in 1997 and replaced by REG-209824-96, January 13, 1997, "which were complicated and also drew immediate criticism."[4] When Congress received word that the Treasury was "creating laws" with this proposed Reg., the IRS was prohibited from making any of the proposed regulations final until July 1, 1998. As of 2006, there are still no "final" versions of this regulation; however, self-employment taxation of LLC members was a "hot" topic in 1997, and the issue remains a "hot" topic today, as witnessed by the barrage of articles on the subject, as seen in the *Tax Advisor*, September 2003, April 2004, and October 2004, and in *Crain's Cleveland Business* of January 9, 2006, just to name a few. These articles basically stated that there are no "final" rulings from the proposed regulations — only exceptions to which members are ***exempt*** from Self-Employment taxes.

Further, since states have granted limited liability to the members of LLCs (which are basically partnerships taxed as a corporation), the IRS has had a problem collecting employment taxes from LLCs, as the members are exempt from liabilities of the LLC. Even though the IRS was restricted from further "final" rulings on Sect 1.402 and Reg 209824-96, these have not kept the Commissioner of the IRS out of Tax Court. In People Place Auto Carwash, LLC v Commissioner, 2006 U.S. Tax Ct. LEXIS 19: 126 T.C. no. 19, the court held that, "As an LLC, petitioner is a separate legal entity from …for Federal tax purposes, petitioner is the "employer" within the meaning of section 3403; accordingly, the liability for the employment taxes is petitioner's…the imposition of employment tax on petitioner cannot be viewed as equivalent to the imposition of employment tax on its members." Basically, the LLC (the legal entity) is liable for the payment of employment taxes, not the individual members.

Other cases in District Courts, involving LLCs and employment taxes have shown that limited liability companies are liable for the payment of self-employment taxes when such LLCs are fraudulently organized - United States of America v Fred J. Anderson, Richard Alan Walters, and Deborah A. Martin, 2004 U.S. Dist. LEXIS 22143: 2005-1 U.S Tax Cas. (CCH) P50, 120: 18 Fla. L. Weekly Fed. D 121. Also Anderson, Walters, and Martin were defendants of another District Court case involving the same accusations, 2005 U. S. Dist. LEXIS 1803: 2005-1 U.S. Tax Cas. (CCH) P50.306. Two other District Court cases involved LLCs and employment taxes: Emiel Kandi v United States of America, 2006 U.S. Dist. LEXIS 2687: 97 A.F.T.R..2d (RIA) 721 and Leonard Snider, et al v United States of America, Theresa J. Turley, et al v United States of America, 2005 U.S. Dist. LEXIS 17438: 96 A.F.T.R.2d (RIA) 5728. Two Bankruptcy Court cases involved LLCs and employment taxes: Mueller v Wisconsin Department of Workforce, 243 B.R. 346: 1999 Bankr. LEXIS 1697; Bankr. L. Rep (CCH) P78.088: Collier Bankr. Cas. 2d (MB) 982. As of June, 2006, there have been no Court of Appeals cases dealing with LLCs and employment taxes, nor any Supreme Court briefs or cases as of this date. As seen from these court cases, even though the IRS has no "legal" ruling on the collection of self-employment taxes from LLC members, the IRS still has jurisdiction on the **collection** of employment taxes owed by the LLC.

In People Place Auto Hand Carwash, LLC from above, the court held that the burden of

paying employment tax (remitting this tax) is quite different from the employment tax on its members (self-employment taxes). The court went further and stated that the petitioner (People Place Auto Hand Carwash, LLC) is the employer and is liable for the employment taxes of its employees.

Over the past few decades, the way companies in the U.S. have been conducting business has changed —there is now a more international focus on business ventures, supply chains, and outsourcing. Therefore, the following sections are presented to inform the reader and to stimulate interest in the international global economy.

LLCs IN GERMANY

Since the *Gesellschaft mit heschrankter Haftung* was the first "LLC," the discussion of the international treatment of LLCs will begin with Germany. "On March 19, 2004, the federal ministry of finance (BMF) issued long-awaited guidance on the German tax characterization of U.S. limited liability companies (LLCs) for German income tax and tax treaty purposes. The guidance, which was officially published on March 29, is intended to eliminate uncertainties related to the German tax treatment and classification of US LLCs."[5] If these LLCs are granted and receive "permanent establishment" of its German members in the U.S., then under German tax law, any distributions by the LLC to its members are exempt from taxation under the BMF treaty of March 29.

On the subject of taxation, this new BMF guidance states that if the LLC qualifies as a corporation, the rate on withholding tax is only 5%, instead of the normal 26.1% rate. If the LLC is a flow-through entity (transparent entity) for both U.S. and German tax intentions, then the full withholding tax may apply.

There is only a 2% tax liability on dividend income received by a German shareholder, given that "German tax law effectively exempts 95% of all income received by a German corporate shareholder from German taxation."[6] When income is generated within Germany, this income is subject to German domestic tax laws. If the LLC is a corporation, the BMF guidance will protect its taxation rights. If the LLC is a flow-through entity, and the members are legal residents of areas other than the U.S., tax rates, depending on the tax treaty of that locale, will be enforceable.

The BMF has allowed corporations, partnerships, or branches of a single owner to be classified as an LLC for German tax purposes. Under German tax law, "a foreign entity is classified as a corporation if a comparison shows: (a) the essential characteristics of a corporation under German law with (b) the rules governing the entity under the laws of the state in which it is established and (c) its articles of association demonstrate that the foreign entity legally and economically resembles a German corporation."[7] (In the U.S., LLCs are organized with operating agreements instead of articles of incorporation.)

The BMF has a listing of eight (8) items to decide whether these entities will be classified as LLCs for its tax liability, which is basically the same (with several other items) included in the Uniform Limited Liability Company Act of 1996. Further, ***only*** German tax law will be the deciding item, not the U.S. state law that the LLC was established in, nor the U.S. Check-the-box regulations and Form 8832, will prevail in the determination of German tax liability for U.S. LLCs.

If there is no decisive determination on how to tax the LLC, "the BMF instructs the local tax authorities to treat the U.S. LLC as a corporation for German tax purposes if the majority of criteria 1-5 indicate corporate status, and criteria 6 may be relevant in certain instances."[8] (For clarification, these items are:

1. Centralized management and representation
2. Limited liability
3. Free transferability of interests
4. Profit attribution mechanism
5. Rules for capital contributions and capital preservation
6. Limited or unlimited life)[9]

To clarify the above, "The BGH (Federal Civil Court) held in 2003 that U.S. companies validly formed and existing under U.S. law will be recognized as legal entities in the same way as companies formed under German company law, regardless of the place of their management and control. Given that U.S. state law generally grants LLCs legal entity status, and German tax law generally follows company law, the BGH's decision could have resulted in corporate status of all U.S. LLCs for German tax purposes."[10] With respect to a single-member LLC, "for the first time, the guidance explicitly confirms that it may be possible to treat a transparent LLC with only one member as a U.S. branch of the sole owner for German tax purposes."[11]

LLCs IN JAPAN

With Pacific Rim trading partners increasing for U.S. businesses, and the opportunity for U.S. businesses to operate in Japan, having the correct business organization is imperative, not only for cultural correctness, but also from a taxation point. As of March 22, 2005, the Japanese Legislature proposed a revision to the check-the-box regulations under Japanese corporate law. Effectively, this legislation would eliminate the *Yugen Kaisha (YK),* or LLC for tax purposes, leaving only the *Kabushiki Kaisha (KK)*, a stock corporation, as the only recognized business organization for Japanese corporate law. "For US investors, the choice between a KK and a YK has largely depended upon the difference of treatment for U.S. federal income tax purposes, and the difference of recognition and prestige among the Japanese business community."[12] For U.S. tax considerations, the KK is a *per se* corporation under the CTBR for Form 8832. According to Croker and Hegawa, "If the Check-the-box regulations are not amended to provide grandfather relief for existing companies, complex and possible costly restructuring may be necessary for U.S. companies that use the *Yugen Kaisha* in their Japanese structure."[13] With this proposal, in effect, the YK could be converted to a KK, as a transfer of stock for assets. If this transfer is executed, then, depending on the YK in the corporate structure, stockholders might have to recognize a taxable gain, and if these stockholders were U.S. stockholders, this gain would be subject to Sec. 367(a).

The YK form of business is not really an LLC under current Japanese laws, as the YK must have at least one member with unlimited liability. To reduce this "problem," a YK can become a *Godo Kaisha (GK)* by re-organizing a YK, and then becoming the equivalent of a U.S. LLC. However, there is a slight problem of Japanese registration tax — "0.15 percent of the amount of the stated capital of the re-organizing entity." In addition, the GK would incur significant additional costs for the change-over from the YK to the GK, basically changing all of its documents, signs, etc. — which might be another hefty cost, in addition to the 0.15 percent tax on re-organization. These proposals are to be effective no sooner than April, 2006. As of this date, any YK will be automatically converted to a KK, as a matter of law. Pursuant to Tax-

Treaties-RPTR letter No. 187, dated December 20, 2005, the effective date of this law is "yet to be determined."[14]

Tax-Treaties-RPTR letter No. 187, points out that a YK can retain its eligibility for purposes of Reg.301.7701-1-3 by becoming a *Tokurei Yugen Kaisha (TYK)*. These TYKs "will remain an eligible entity that may elect its U.S. tax classification."[15]

LLCs IN CANADA

The Canadian border with the United States is just a physical "limitation" for businesses in either country to operate or generate income in either country. Companies that are established in both countries, or contemplating operating in both countries, or just in Canada, may wish to rethink their business organization -- as Canada recognizes the LLC as a business entity, but taxes this entity as a corporation. "In general, anyone employed, carrying on a business or earning pension or investment income in Canada or disposing of Canadian assets is subject to tax. If a taxpayer meets Canadian residency criteria, the taxpayer is subject to tax on worldwide income rather than just Canadian-source income."[16]

In the United States, LLCs are really partnerships, and if not elected on Form 8832, these partnerships are treated as partnerships for tax purposes, with the earnings flowing through to the partner to be taxed at his/her personal tax rate. In Canada, these LLCs are considered as corporations and taxed as such. Even if the LLC is legally established by a state within the U.S., and generates income from a Canadian source, this income will be taxed at the higher rates of Canada.

Canadian tax laws state that corporations are corporations and partnerships are partnerships. Also there are no S Corporations or Check-the-box regulations for having the tax liability flow through to the owners — just plain "vanilla" regulations. As such, if an individual invests in a Canadian corporation and receives a corporate dividend, then this dividend is subject to **both** countries' tax laws — a Canadian tax on the corporation's income and a U.S. tax on the dividend income.

Canada has entered into a tax treaty that has been helpful, in some respects, in alleviating the above situations. However, Canada still does not recognize an LLC to be a corporation, nor does Canada recognize an S Corporation as a flow-through entity. LLCs are partnerships with the partners' residency establishing the rules for taxation, and S Corporations are corporations, and as such are the legal tax paying entity.

"An entity will be considered to be carrying on business in Canada if it derives income (sales) from Canadian sources generated by either a dependent or independent agent."[17] Without the tax treaty with Canada, the branch tax on this income would be 25%, instead of only 5%. However, "if an LLC acquires a share of a Canadian company to avoid the branch tax rate, any dividends paid by the Canadian company will be subject to a 25% withholding tax, as opposed to the 5% treaty rate. A lower rate is available when more than 10% of the shares of a Canadian corporation are owned by a U.S. corporation."[18]

As there are now tax treaties in place, the "S Corporation will only be subject to full Canadian tax on its business profits if it carries on business in Canada through a permanent establishment. An S corporation will still be subject to Canadian tax on its Canadian operations carried on through a permanent establishment."[19]

The province of Nova Scotia allows an organization to form an unlimited liability company (ULC), which will qualify for the CTB regulations, but not the limited liability protection. This organization is the only way an "LLC" can operate in Canada. Remember that Canada considers LLCs as partnerships for tax purposes. These ULCs, "should always be used in conjunction with an LP or an S corporation. (Because LLCs cannot avail themselves of treaty benefits, they should not hold shares of a ULC)."[20]

"As a Canadian subsidiary of an S Corporation, a ULC will insulate the S Corporation from filing returns in Canada. The ULC can return capital invested before returning retained earnings, and any earnings repatriated through dividends to the S Corporation will be subject to only a 5% withholding tax."[21] The ULC, for U.S. tax rules is a flow-through entity. Any business that this ULC generates in the U.S. is subject to Canadian taxes, and no foreign tax credit will be available to offset the Canadian tax liability on this income.

LLCs IN PUERTO RICO

In 2004, the Puerto Rican legislation approved a bill that would allow LLCs in Puerto Rico. "It is a law that allows maximum flexibility,"[22] as stated by Antonio Escudero, a corporate law professor at the University of Puerto Rico. Under this law, both foreign and domestic LLCs are afforded treatment as corporations, especially for tax purposes. If an LLC has fewer than 35 members, the members can elect to Subchapter N status, and have the tax liability flow through to them personally, and negate the tax liability for the LLC. For LLCs with 35 members or greater, the LLC is required to pay taxes as a corporation. Foreign LLCs, from the U.S. and non-U.S., only have to file for authorization to conduct business in Puerto Rico, with non-U.S. LLCs becoming " 'naturalized' by following the procedures contained in the act."[23]

LLCs IN THE UNITED KINGDOM AND IRELAND

By English Law, a limited company by shares (limited or Ltd.) is a limited company whose liability is limited to the capital invested — thus the reference to "shares." These companies can be either Public or Private, with most being private and distinguished by the shares available to the public.

The designations of these limited liability companies in Ireland are: "Teoranto ("Teo") may be used instead, though this is limited mainly to Gaeltacht companies. "Cyfyngedig" ("Cyf") may be used by Welsh companies in a similar fashion."[24] These limited liability companies are taxed at corporate rates, and any dividends distributed to shareholders are further taxed. In 2002, "the UK legislated limited liability partnerships (LLPs) into existence, which more closely proximate LLCs in the U.S.A."[25]

LLCs IN THE EUROPEAN UNION

Check-the-box Regulations were amended to include the *per se* entity, *Societas Eurpoaea (SE),* which is a new European Union entity, which functions as a "public limited liability company,"[26] or "European public limited liability company."[27] Recall that *per se* entities are entities that are taxed as corporations and do not have to file a Form 8832, as listed in Reg. 301.7701-2(b)(8). This action was effective December 16, 2005, by way of Temporary Reg TD 9197 and Proposed Regulation REG-148521-04,4/13/05. Also included in these regs were: "*Estonia Atsiaselts, Latvian Akciju, Lithuanian Akcine Bendroves, Slovenian Delniska Druzba, and Liechtenstein Aktiengesellschaft,"*[28] as new *per se* entities.

The above explanations and discussions are not meant to be the only countries that tax U.S. LLCs. The list included the countries that most Americans would be most likely to conduct business in or to possibly invest in entities that would conduct businesses in these countries.

CONCLUSION

Taxation of LLCs in the United States is handled through a mirade of vehicles including the Internal Revenue Code (IRC), Proposed Federal Regulations, and court case rulings. Persons wishing to form an LLC and/or learn how this entity will be taxed have very few obstacles to overcome because the United States has structured this information in relatively easy to find places with relatively easy to understand information. However, in certain countries, the information is not as readily accessible, thus the impetus for this article. This article has investigated or shown the basic formation and taxation of LLCs in the United States, and compared it with formation and/or taxation of an LLC in Germany, Japan, Canada, Puerto Rico, United Kingdom, Ireland, and the European Union. It is not the intent of this article to be all encompassing, rather it is a beginning, to impart knowledge to those individuals who are now doing business in these countries or may wish to do business in these countries in the future. Additional opportunities for research could make additional comparisons to other countries using the LLC or some variation. To this end, we, the authors, are in anticipation that, at a future date, we can expand our listing above to include several more countries.

ENDNOTES

1. Calvin, Fink, "Taxation of Limited Liability Partnerships (LLPs) & Limited Liability Companies (LLCs), A Research Paper," unpublished (November, 2000), pg 5

2. www.llcproject.org/ullca ASP.NET Portal, page 1

3. Calvin, Fink, "Taxation of Limited Liability Partnerships (LLPs) & Limited Liability Companies (LLCs), A Research Paper," unpublished (November, 2000), pg 14

4. Ellen M. Beck, *Tax Advisor*, (October, 2004). Vol 35, Issue 10, p 616

5. Norbert Endres and Andreas Kowalik, "Officials clarify character of LLCs," *International Tax Review*: (May, 2004), Vol 15, Issue 5, pg 21

6. Ibid, pg 22

7. Ibid, pg 22

8. Ibid, pg 22

9. Ibid, pg 22

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A GRANT PROGRAM TO PROVIDE INCENTIVE AND REWARD FOR RESEARCH PRODUCTIVITY

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Abstract: This article describes a grant program that can provide incentive and reward for research productivity. The program would make grants based upon a proposal and the publication of articles during the previous year, thus recognizing both proposal quality and past research productivity. Another major strength of this grant program is that it is flexible enough so that the basic framework can be used by virtually any type of academic unit. The suggestions in the article are intended to be guidelines that academic units can use or adjust depending on the availability of funds, composition of faculty, and types of academic programs offered. The system also has the advantage of allowing for periodic adjustments to incorporate changes and is in conformity with the basic fundamental tenets of the current AACSB accreditation process of "continuous improvement."

INTRODUCTION

Many departments, colleges, and universities have faced difficulties in obtaining research publications by their faculty members. The most frequent deficiencies in research[1] encountered by academic units are in the area of the publication of journal articles in refereed outlets. Faculty members, however, do often participate in the writing of textbooks or handbooks because this is closely related to teaching and/or it may result in royalties that convince them that the investment of time indeed has a direct or clear-cut payoff. Additionally, they may participate in the writing of pedagogical works, because this is closely related to some specific aspect of their teaching, or in national or regional conference presentations and proceedings because the obtaining of acceptances in these outlets may be less difficult than in journals.

It is the publication of articles in quality academic and professional journals that can most often be frustrating and time-consuming. With lengthy review processes and revisions, coupled with an uncertainty regarding salary increases and other rewards, there appears often to be little or no incentive for publishing, especially by the tenured faculty members.

A common problem for academic units that do have the financial resources to award research grants is that there often is little or no follow-up as to how successful the grant investment has been. That is, there frequently is the very real question of whether faculty members actually do produce the journal articles they were expected to and for which they were granted financial support. Some academic units do "require" a written report after the grant, but rarely, if ever, do faculty members actually have to pay back the grant if no publication is forthcoming.

Against this context, the present article describes an alternative form of research grant program that would recognize past productivity in the determination of the amount of the grants. In short, the research grant program would make grants based upon a proposal and the publication of articles during the previous year. It is important for a program such as this to have stated objectives and to be able to justify the program to academic units within the university that might not have the financial resources to offer such a program. Accounting units

often do have private financial resources from endowments, alumni fund drives, continuing education programs, or contributions from accounting firms, industry, etc.

OBJECTIVES

It is important for an academic unit to have stated objectives so that there is a rationale for the procedures. Further, the decision as to whether additional changes are to occur later can be made in terms of whether or not changes will meet the stated objectives.

The objectives of the research support grant program here described are:

1. To attempt to assure that the level of intellectual contributions (research publication in journals) is sufficient to surpass or at least meet the AACSB accounting accreditation expectations.
2. To help meet the goal of obtaining publication of articles in the highest level(s) of journals reasonably possible.
3. To attempt to obtain as wide participation in the journal publication process by the faculty members as regarded plausible.
4. To attempt to obtain as regular participation in the journal publication process by the faculty members as reasonably warranted.

The desire to obtain and retain accreditation is always an influence on the activities of an academic unit. A significant part of the accreditation process involves verification or compliance with the "intellectual contribution" expectations of the American Assembly of Collegiate Schools of Business (AACSB) and the visiting accreditors (objective #1). Further, virtually every university, college of business, and department unit has as a major objective the publishing of articles in the highest level of journals possible (objective #2).

Many academic units have only a small percentage of their faculty publishing in the desired outlets. Thus, a worthy goal is one that encourages as many faculty members to participate as possible (objective #3). That is, it should not just be those faculty members seeking to obtain tenure and/or promotion who are publishing, but senior, tenured faculty members ought also to be publishing. In addition, faculty members should not just have a "spurt" of publications around the time of tenure or promotion or accreditation visits, but they should be active in the publication process on a continuing and regular basis (objective #4).

JUSTIFICATION

From a philosophical standpoint, one might question a program that has as a major determinant of the grant the past research record of the faculty member. That is, one might claim that the faculty member should not receive monetary recognition beyond the usual channels of promotion, tenure, salary increases, research release, etc. However, arguments can be advanced that do justify the type of program outlined in this article. Such a program is, in fact, justifiable for the following supporting reasons:

1. The opportunity for research release is not as great as it was in the past. Academic budgets have been cut significantly or made leaner. Faculty members are expected to participate in more activities with less resources.
2. Salary increases have been poor, unpredictable, or irregular.
3. Many departments of Accounting have had to deal with the separate AACSB accounting accreditation issues and with the demands imposed by the 150-hour

requirement to sit for the CPA exam. Both of these factors have caused Departments to expend great amounts of time on curricular revisions, and on modifications to both the undergraduate and graduate programs.

4. The AACSB accreditation rules and the 150-hour requirement have put heavier demands for service commitments on faculty, thus leaving less opportunity or incentive to do research. Yet, demands for research are still present in the AACSB rules, and in fact, the guidelines require "continuous improvement."
5. The Accounting Education Change Commission and accounting firms place great emphasis on innovation in teaching, including technology and problem-based learning innovation. Compliance with these expectations takes extra time from faculty members.

Some of these justifications exist for any academic unit, regardless of discipline. Most units are concerned with accreditation, whether it is separate accounting accreditation, college of business accreditation, or regional university accreditation. Further, salary increases or research release often affect in a similar way the whole university, not just a particular academic unit.

Most academic accounting units in this country, however, are faced with at least some of the same problems cited above and a number of units may have all of the indicated problems. Thus, they could use these points as justification to non-accounting academic units that might not have the resources that accounting units have to carry out such a research grant program.

Some of these justifications (#'s 3, 4, and 5) do affect only accounting units. The separate accounting accreditation issues are not faced by departments of marketing, management, finance, or economics. Accounting units in the many states that have passed the 150 hour requirement to sit for the CPA exam are concerned about curricular modifications and likely devote an enormous amount of time to such endeavors.

PROCEDURAL RULES

The procedures named and described are written with the intent to accomplish the stated objectives and to prevent abuses that might occur.

Eligibility

1. *To be eligible for research support, a research proposal will be presented in writing by a specified early Spring semester date for consideration for summer research support for the summer of that same year.*

   The requirement of a research proposal is made with the hope that faculty members will proceed with a new research project. The submission of a slip-shod proposal merely to satisfy the requirement will not likely result in a very high-level publication.

Research Support and Journals List

2. *Research support will be based on the publication of journal articles during the preceding year and will be as follows for Department of Accounting tenured or tenure track faculty members returning for the following academic year, subject to the (illustrative) criteria below:*

For one "A+" article: $4,500
For one "A" article: $3,000
For one "B" article: $1,500
For one "C" article: $400 for one; $500 for two: $600 for three or more (no recognition for repeating journals in the same year in category C).

The word "publication" means that the article has been published in a journal with the university contributing the grant listed as the faculty member's affiliation. The intention of this stipulation is to avoid the situation where a faculty obtains a research grant, moves to another university, and puts that university's affiliation on the article. Actual publication is expected, rather than simply a letter of acceptance or receipt of galleys, both of which are viewed as being subject to possible modification or change.

The word "article" means a full-length exposition, beyond a "comment," brief discussion of other authors' work(s), letter to the editor, book review, etc. Admittedly, this may be subject to interpretation, but an ad hoc committee should be formed to deal with the issue of whether a given work qualifies as a full-length exposition (as well as with other issues).

In order to have a research program, it is important to have a journals list. The illustrative categories of "A+", "A", "B", and "C" should be based on College of Business guidelines with some modifications to fit the academic and professional nature of the field of accounting. A journals list could be compiled in any way that meets the goals of the University, College of Business, or Accounting unit and would be influenced by AACSB accreditation standards.[2] Interpretations on types of research are similar to the following. A doctoral granting institution would construct its categories to emphasize basic scholarship, with little or no emphasis on applied scholarship or pedagogical research. Schools with greater emphasis on graduate instruction compared to undergraduate instruction might place emphasis on both basic and applied scholarship. Schools with mainly undergraduate programs might emphasize applied scholarship and pedagogical research. Those schools with graduate and undergraduate programs, but no doctoral programs, might have a balance among basic scholarship, applied scholarship, and pedagogical research.

As an illustration, for a school with a mix of undergraduate and graduate programs but no doctoral program, a departmental journals list could be as follows, which, more or less, would be consistent with the above AACSB guidelines. The "A+" journals would include the very highest academic accounting journals, e.g., *The Accounting Review*, *Journal of Accounting Research*, etc. The “A" journals would include American Accounting Association section journals, other accounting/tax academic journals, and law reviews. The "B" journals would include the better professional or practitioner accounting/tax journals and several education journals. The "C" journals would include the lesser professional or practitioner accounting/tax journals. As can be seen, "C" journals articles would not be given much recognition, but would be included so that even the articles in lesser journals would at least get some recognition. However, the publication of articles in the "C" category of journals would not be encouraged as are the other categories.

A journals list is never an easy matter with which to deal. It is best if some outside source is available to be used in compiling the list. For example, rankings of journals as described in the Accounting Horizons 1990 ranking of journals[3] can provide some helpful guidance. Certain sub-disciplines of Accounting have rankings and law reviews are also ranked. Without the use of an outside ranking source, the process can readily become quite political. For example, attitudes such as the following can surface: what Professor X publishes should

rank high, while what Professor Y publishes should rank lower, etc.

Dollar amounts of rewards can be adjusted to take into account available resources, the number of faculty publishing, the frequency of publishing by faculty members, and the level of publishing itself (the more sophisticated academic journals versus lower level practitioner journals).

Co-authorship

3. *If articles are co-authored, the amount of research support given to one individual will be divided by the number of co-authors, regardless of the departmental or university affiliation of the co-authors.*

Without this stipulation, there would be a tendency for many authors to try to be listed on a given publication or a faculty member could find cronies at other universities with whom to publish. As stated above, on the other hand, if a triple-authored "A" article is published and all three authors are faculty members at the university offering the program, each would receive $1,000 under the outlined program.

Effect on Other Perquisites

4. *The research support grants will not affect the summer teaching priorities or college-wide research grant priorities.*

It would be counterproductive to penalize faculty members receiving these grants by reducing their opportunities for summer teaching or other research grants. To have the desired effect, the grant program must be beyond what they otherwise would receive. Thus, if faculty members are teaching and/or have research support from College of Business or University sources, they are not precluded from obtaining research support from the Department.

Periodic Adjustments in Journals List

5. *The Department of Accounting journals list will be used as a basis for the research support. Periodic adjustments in the list will continue to be made, as needed, based on input or information from faculty or other sources. The journal list is subject to periodic review with classification of journals subject to the approval of the departmental Chair and College of Business Dean. In the event appropriate accounting/tax-related articles are published in journals not on the Department of Accounting list, the Chair and Dean will review those journals for possible consideration.*

It is important to have period adjustments in the journals list, and input from faculty members should be obtained. However, the Chair and Dean should give final approval.

6. *Both the research support grants and the journals lists are subject to the approval of the Chair and Dean.*

A journals list can never properly be regarded as a fixed list. Periodic adjustments are necessary to incorporate new information or rankings and new journals that may have been added. Some monitoring of this process by the Chair and Dean is necessary to reduce the possibility that additions or deletions are based on purely self-interest or political

considerations.

Sometimes Accounting faculty publish with faculty in other disciplines. For example, faculty in the Department of Accounting might publish with faculty member(s) in the Department of Finance in a finance journal. It is likely then that, if the article is deemed to be an appropriate accounting/tax-related article, the ranking on the Department of Finance journal list could be considered for the Department of Accounting faculty member. On the other hand, if a marketing article is published with a Department of Marketing faculty member and the article has no relation to accounting/tax subject matter, the article should not be considered.

Making the research support grants and journals lists subject to the approval of the Chair and Dean helps assure that the publications process is in line with Departmental, College of Business, and University goals. The ad hoc committee can serve here also to provide some input in the process for the Chair and Dean. However, excessive dictating of policy by faculty members could result in "politics" influencing the whole process, which is not desirable when the Chair and Dean are key figures held responsible for maintaining quality programs.

Change in Faculty Status

7. *No research support will be given to faculty members who (1) have been issued a termination appointment or (2) are resigning or retiring, effective during the academic year following a faculty member's consideration for research support.*

One could argue that awarding a research grant to a terminated or resigning faculty member would not be in line with the AACSB objective outlined above since the terminated faculty member would not likely be included in the "intellectual contribution" record of the Department at the time of an accreditation visit. Carried to the extreme, one could argue that only those faculty members who were on the faculty when the self-evaluation for accreditation purposes occurred should be recognized in a research grant program such as this. However, such action would simply not be feasible from a practical standpoint. Faculty members would likely be quite unhappy if they had to wait until that point to obtain recognition for their research output. Instead, some reasonable way has to be found to recognize faculty members on a timely basis, yet not have the program be subject to an excessive number of potential abuses.

One possible approach would be that support should not be provided for those who are not going to be at the University for at least one more year. This would be consistent with policies often used for other purposes within a College of Business or University.

Availability of Funds and Periodic Evaluation

8. *This program is conditional upon the availability and/or alternate uses/need for funds as determined by the departmental Chair and College of Business Dean with input from the faculty.*

9. *The program will be evaluated periodically by the Chair and Dean (with input from the faculty) for effectiveness in accomplishing the goals.*

It is difficult to predict the monetary outflows that might occur in the future resulting from a

program as described in this article. With periodic review by the Chair and Dean, one could modify the program by reducing the size of grants, for example, if more payments were made than expected or if some major alternative expenditure(s) of funds were necessary. Alternatively, if the program were deemed to be effective but available funds were being depleted too rapidly, additional fund drives or specific monetary solicitations from various firms or stakeholders could be made.

OVERVIEW

The approach to research-fund allocation described above represents an attempt to enhance several major purposes, among them (a) the stimulation of faculty research effort and achievement of research productivity; (b) the realization of discernible high-level research output to maximal extent on the basis of given, often somewhat limited, special research-support funding; and (c) the enhancement of the belief among faculty members that funding is awarded on an equitable basis. Such a program has desirable goals, and so accordingly merits consideration by interested observers. Other departments or Colleges of Business, in turn, could use the described approach, in its entirety or in adapted form.

If success follows, certain worthy benefits can reasonably be expected. For example, published research productivity may grow larger. Again, faculty morale may benefit as merit triumphs over politics or “personalismo.” And, of course, the process of fair implementation by the administrators themselves can be helped.

It would seem, at least, that allocation of special research funds with reference to some assurance of resultant output is to be preferred over the all-too-common practice of responding with funds for faculty who persist in holding out for "pay-off" before they will attempt to publish. The central premise at issue is that tangible product is a better "pay-off" than promise, per se.

CONCLUSIONS AND RECOMMENDATIONS

A major strength of this grant program is that it is flexible enough so that the basic framework can be used by virtually any type of academic unit. It can be used to design a system that will encourage the types of intellectual contribution that an academic unit will be expected to carry out, given its mission and objectives. The specific suggestions in this article are not intended to be applicable to every academic unit, but are intended to be guidelines that academic units can use or adjust depending on the availability of funds, composition of faculty, and types of academic programs offered.

A further major strength is that this grant program recognizes past research productivity in awarding research grants. Too many research grant programs currently have little or no accountability and all too frequently are viewed as "boondoggles."

Even when an academic unit develops the initial program, this does not mean that periodic reviews and adjustments are not necessary. Indeed, the system has the advantage of allowing for periodic adjustments to incorporate changes and is in conformity with the basic fundamental tenets of the current AACSB accreditation process of "continuous improvement."

ENDNOTES

[1] In this article, the word "research" is interchangeable with the AACSB usage of "intellectual contributions."

[2] *Eligibility Procedures and Standards for Accounting Accreditation*, AACSB International, 2005.

[3] R. Hull and G. Wright, "Faculty Perceptions of Journal Quality: An Update," *Accounting Horizons*, vol. 4, no. 1, March 1990, pp. 77-98.

ETHICS EDUCATION FOR CPAS: A GROWING TREND

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ABSTRACT: In February of 2005, the National Association of State Boards of Accountancy issued an exposure draft of proposed revisions to the Uniform Accountancy Act. If adopted, these revised rules would have required a minimum of three semester hours in ethical and professional responsibilities of CPAs, and three semester hours in ethical foundations and applications in business as part of the educational requirements for sitting for the CPA examination. Delaware requires that applicants for the CPA certificate successfully complete the AICPA self-study program Professional Ethics for CPAs. Beginning in 2007, Minnesota CPAs will be required to complete a minimum of 8 hours of continuing professional education in accounting or business ethics over a three year period in order to renew their certificate. These, and many other changes related to ethics education are beginning to make their way into state accountancy laws and rules. The purpose of this paper is to analyze the accountancy laws and rules of the 54 state boards of accountancy that regulate the practice of accounting to determine what specific ethics educational requirements are in effect today. This analysis looks at the ethics education requirements to sit for the CPA examination, the ethics requirements to be licensed in the first place, and the ethics education requirements for renewal of the CPA certificate. The analysis related to certificate renewal is made within the overall continuing professional education umbrella. The results of the analysis show a growing trend in state mandated ethics education for CPAs.

INTRODUCTION

In January 2006, Enron's former chairman Kenneth Lay went on trial for one of the largest corporate frauds in US history. He was joined in that trial by Jeffrey Skilling, Enron's former CEO, and Richard Causey, the former chief accountant. David Duncan, the lead Andersen partner in charge of the Enron audit pleaded guilty to obstruction of justice in 2002. In that same year, Andersen was convicted of obstruction of justice. Although Andersen's conviction was overturned in 2005, it resulted in the demise of the once mighty international accounting firm.

The personal, political, and professional fallout from the Enron scandal will likely be felt for a number of years to come. On the personal side, tens of thousands of people lost their jobs, and found themselves in financial ruin. On the political side, Congress reacted by passing the Sarbanes-Oxley Act of 2002. Many view Sarbanes-Oxley as the single most important piece of legislation affecting corporate governance, financial disclosure, and the practice of public accounting since the 1930's securities acts. On the professional side, accountants are finding themselves subjected to increased scrutiny as they discharge their duties. Because of Enron and numerous other recent accounting scandals, legislators, regulators, and accrediting bodies are demanding that more emphasis be placed on ethics education.

In February of 2005, the National Association of State Boards of Accountancy (NASBA) issued an exposure draft of proposed revisions to its Uniform Accountancy Act (NASBA,

February 28, 2005). This exposure draft recommended a minimum of three semester hours in ethical and professional responsibilities of CPAs, and three semester hours in ethical foundations and applications in business as part of the educational requirements for sitting for the CPA examination. The Education Committee of the NASBA ultimately recommended against adoption of this requirement. In October of 2005, the NASBA Board accepted the recommendation of the Education Committee not to move forward with the ethics requirement (NASBA, October 28, 2005).

Many states require that applicants for the CPA certificate successfully complete the AICPA self-study program Professional Ethics for CPAs. In addition, a growing number of states require continuing professional education in accounting or business ethics for certificate renewal. These, and other changes related to ethics education are beginning to make their way into state accountancy laws and rules.

The purpose of this paper is to analyze the accountancy laws and rules of the 54 state boards of accountancy that regulate the practice of accounting to determine what specific ethics educational requirements are in effect today. This analysis looks at the ethics education requirements to sit for the CPA examination, the ethics requirements to be licensed in the first place, and the ethics education requirements for renewal of the CPA certificate. The analysis related to certificate renewal is made within the overall continuing professional education (CPE) umbrella. The next section of the paper discusses the methodology used to analyze the accountancy laws and rules. This is followed by a discussion of the CPE requirements in general for license renewal. Next is an analysis of the specific ethics requirements to sit for the CPA exam and to be licensed. Finally concluding comments are offered.

METHODOLOGY

The National Association of State Boards of Accountancy (NASBA) serves as a forum for 54 individual state boards of accountancy. The actual requirements to sit for the CPA examination and to be licensed as a CPA rest with the individual state boards of accountancy. These requirements are found in the state boards of accountancy laws and regulations. Of the 54 jurisdictions overseen by NASBA, 50 provide sufficient information on their websites to allow for the analysis. The four that did not provide adequate information are the District of Columbia, Guam, New Jersey, and Puerto Rico.

The laws and regulations of 50 state boards of accountancy are examined so that the following questions can be answered:

In general, how many hours of CPE per period are required for license renewal?
What is the minimum number of hours of ethics for license renewal?
What is the minimum number of hours of other specific content required for license renewal?
What is the maximum number of hours of specific content allowed for license renewal?
How many hours of excess CPE hours can be carried over to subsequent periods?
Is there an ethics educational requirement to sit for the CPA examination? If so, what is the nature of the requirement?
Is ethics included in the business hours required to sit for the CPA examination?
Is an ethics examination required for first time licensure of CPAs? If so, what is the nature of the examination?
Is an examination required for license renewal? If so, what is its nature?

CONTINUING PROFESSIONAL EDUCATION REQUIREMENTS IN GENERAL

The analysis of the CPE requirements in general includes 50 jurisdictions overseen by NASBA. Excluded are the District of Columbia, Guam, New Jersey, and Puerto Rico. The number of hours of CPE required during the reporting period fall into one of three categories as shown in Table 1: 40 hours per year; 80 hours every two years; or 120 hours every three years. Six states require forty hours per year. Twenty one states require either 80 hours every two years or 120 hours every three years. Neither Wisconsin nor the Virgin Islands requires CPE hours for license renewal.

TABLE 1
REQUIRED CPE HOURS FOR LICENSE RENEWAL

40 Hours/Year	80 Hours Every Two Years	120 Hours Every Three Years
Alabama, Connecticut, Mississippi, New York, North Carolina, South Carolina	Alaska, Arizona, California, Colorado, Delaware, Florida, Georgia, Hawaii, Idaho, Kansas, Kentucky, Maryland, Massachusetts, Michigan, Nebraska, Oregon, Pennsylvania, Tennessee, Utah, Vermont	Arkansas, Illinois, Indiana, Iowa, Louisiana, Maine, Minnesota, Missouri, Montana, New Hampshire, New Mexico, North Dakota, Ohio, Oklahoma, Rhode Island, South Dakota, Texas, Virginia, Washington, West Virginia, Wyoming

Of the 50 jurisdictions analyzed, 29 require some form of ethics or fraud detection CPE for license renewal. As shown in Table 2, the number of hours required varies from two hours per reporting period to eight hours per reporting period. The minimum requirement is found in Indiana and Montana, each of which requires two hours out of a total of 120 hours every three years. This represents less than two percent of the total CPE requirement.

TABLE 2
REQUIRED HOURS OF ETHICS FOR LICENSE RENEWAL

Ethics Requirement	States
Two Hours Per Year	Michigan, Missouri, North Carolina, Oklahoma
Two Hours Every Two Years	Colorado, Kansas
Two Hours Every Three Years	Indiana, Montana
Three Hours Every Three Years	Virginia, Wyoming, Ohio
Four Hours Every Other Year	Texas
Four Hours Every Two Years	Arizona, Delaware, Florida, Iowa, Maryland, Nebraska, Vermont
Four Hours Every Three Years	Arkansas, Illinois, Louisiana, Maine, New Hampshire, New York, Washington
Four Hours Every Four Years	Oregon
Six Hours Every Three Years	Rhode Island
Eight Hours in Fraud Detection Every Two Years	California

Of the 29 states that require CPE hours in ethics for license renewal, 12 specify the type. Arizona, Vermont, and Virginia require that the CPE focus on the AICPA Code of Conduct and the state board statutes and administrative rules. The remaining states require CPE that relates

to ethics or state rules of professional conduct.

The majority of the states establish some minimum criteria for the CPE. These criteria are categorized as relating to accounting and auditing (A&A), number of hours per year, environment, and other. Table 3 shows the breakdown by category.

As Table 3 shows, there is substantial variation in the minimum CPE requirements across the jurisdictions included in this study. Of the 50 jurisdictions included, 15 had no minimum CPE requirement at all. For the 15 states that had minimum required hours of A&A, the percentages range from 10% to 60%. Nineteen states require a minimum number of hours of CPE per year, with the percentages ranging from 6.7% to 50% per year. Three states require that at least some of the required CPE take place in a face-to-face environment.

TABLE 3
CATEGORIES OF MINIMUM REQUIRED CPE HOURS

Minimum Hours of A&A
8 hours/40 hours (20%): Alabama, Mississippi
8 hours/80 hours (10%): Michigan, Vermont
12 hours/120 hours (10%): Indiana
16 hours/80 hours (20%): Georgia
20 hours/80 hours (25%): Florida
24 hours/120 hours (20%): Montana, Rhode Island
32 hours/80 hours (40%): Colorado
40 hours/80 hours (50%): Arizona, California, Nebraska, Tennessee
72 hours/120 hours (60%): Arkansas
Minimum Hours per Year
8 hours/120 hours (6.7%): Rhode Island
20 hours/80 hours (25%): Alaska, Georgia, Kansas, Nevada, Pennsylvania, Tennessee
20 hours/120 hours (16.7%): Minnesota, Missouri, New Hampshire, North Dakota, South Dakota, Texas, Virginia
24 hours/80 hours (30%): Oregon
30 hours/80 hours (37.5%): Idaho
40 hours/80 hours (50%): Nebraska, Vermont
40 hours/120 hours (33.3%): West Virginia
Minimum Hours in CPE Environment
8 hours/40 hours (20%) not in self-study: North Carolina
20 hours/120 hours (16.7%) in live classroom: Texas
24 hours/120 hours (20%) in public presentation: New Mexico
Other Minimum
7 hours Financial Statement Presentation/120 hours: Iowa
16 hours A&A and 8 hours Tax/80 hours: Pennsylvania
16 hours A&A and 16 hours Tax/80 hours: Delaware
24 hours A&A, 24 hours Tax, 3 hours Professional Standards/120 hours: Ohio
72 hours Practice Related/120 hours: Oklahoma
96 hours Technical/120 hours: New Mexico

Thirty-three out of the 50 jurisdictions included in the study establish some type of maximum related to CPE. The categories relate to the type of CPE, the format or environment in which the CPE is obtained, and hours per year. The results are shown in Table 4.

Table 4
CATEGORIES OF MAXIMUM HOURS OF CPE

Type of CPE
Behavioral:
8 hours/40 hours (20%): Alabama
20 hours/80 hours (25%): Florida
24 hours/120 hours (20%): South Dakota, Wyoming
Non-Accounting Related:
20 hours/40 hours (50%): Rhode Island
20 hours/80 hours (25%): Arizona
24 hours/120 hours (20%): Rhode Island
40 hours/80 hours (50%): California, Nebraska
CPE Format
Presenter
20 hours/40 hours (50%): Connecticut, Maine, North Carolina
40 hours/80 hours (50%): Arizona, Delaware, Hawaii, Maryland, Massachusetts, Nebraska, Pennsylvania, Tennessee
48 hour/80 hours (60%): Kentucky
60 hours/120 hours (50%): Indiana, South Dakota
72 hours/120 hours (60%): Washington
Author of Publication
10 hours/40 hours (25%): Connecticut, North Carolina
10 hours/80 hours (12.5%): Maryland
10 hours/120 hours (8.3%): Texas
20 hours/40 hours (50%): Maine, New York
20 hours/80 hours (25%): Arizona, California, Delaware, Hawaii, Kentucky, Michigan, Pennsylvania, Utah, Vermont
30 hours/120 hours (25%): Illinois, Iowa, Virginia, Washington, Wyoming
60 hours/120 hours (50%): New Hampshire, Tennessee
Self-Study
20 hours/40 hours (50%): Maine
20 hours/80 hours (25%): Michigan
24 hours/80 hours (30%): Delaware
40 hours/80 hours (50%): Maryland, Nebraska, Pennsylvania
60 hours/120 hours (50%): Illinois, Indiana, Iowa
80 hours/120 hours (66.7%): Rhode Island
Combination
Presenter and Author – 40 hours/80 hours (50%): Arizona
Author and Self-Study – 72 hours/120 hours (60%): Arkansas
Presenter, Author, and Self-Study – 64hours/80 hours (80%): Vermont
College Credit – 40 hours/80 hours (50%): Nebraska
Hours Per Year: 50 hours/80 hours (62.5%) - Idaho

As Table 4 shows, the maximums related to hours of CPE are as varied as the minimums shown in Table 3. Nine of the states limit the number of hours of non-accounting types of CPE, with four of the nine specifically limiting CPE relating to behavioral subjects. The majority of the CPE limits focus on the format in which the CPE is presented. The limiting formats include the presenter or instructor of the CPE, author of articles, self-study CPE, and college courses. Thirteen of the states specify that a maximum of 50% of the hours of CPE can come from the presenter format, while two states limit the maximum to 60% of the hours. The maximum percentages related to publications range from 8.3% to 50%. Ten of the states restrict the hours that can be obtained by self-study, with the percentages ranging from 25% to 66.7%. Only one state limits the number of hours of CPE that can be obtained per year.

Fifteen of the 50 states included in the study allow individuals to carry over excess CPE hours from one reporting period to the next. The number of hours of carry over ranges from 10 hours out of 80 hours for Vermont, to 10 hours out of 120 hours for New Hampshire. The complete listing is shown in Table 5.

TABLE 5
EXCESS CPE HOURS ALLOWED FOR CARRYOVER

10 hours/80 hours: Vermont
15 hours/80 hours: Georgia
20 hours/40 hours (50%): Connecticut, Maine, North Carolina, South Carolina
20 hours/80 hours (25%): Kansas, Oregon
40 hours/80 hours (25%): Hawaii, Maryland, Tennessee, Utah
60 hours/120 hours (50%): New Hampshire
8 hours A&A, 20 hours Total/40 hours (50%): Mississippi
8 hours A&A, 2 hours Ethics, 30 hours Other/80 hours: Michigan

ETHICS REQUIREMENTS

As previously stated, the NASBA decided against the adoption of a revision of the Uniform Accountancy Act that would have required a minimum of three semester hours in ethical and professional responsibilities of CPAs, and three semester hours in ethical foundations and applications in business as part of the educational requirements for sitting for the CPA examination. Notwithstanding this, Texas, Maryland, and Nebraska have enacted rules that require candidates for the CPA examination to complete a course in ethics education.

The Texas rule, adopted by the Texas State Board of Public Accountancy, requires that CPA examination candidates complete three semester hours of ethics education (VanZante, 2005). Ethics education is defined by the Texas Board as relating to ethical reasoning, integrity, objectivity, independence, and other core values. It is worth noting here that the Board's definition of ethics education goes well beyond professional codes of conduct and professional responsibility. The university courses that the Texas Board has approved as meeting this requirement include Ethics in the Accounting Profession, Ethics in Organizations, Accounting Ethics, Business and Professional Ethics for Accountants, Business Ethics, Business and Professional Ethics, Professional Ethics and Responsibilities, Foundations of Professional Ethics, Professional Ethics and Corporate Governance, and Social and Ethical Issues in Business (TSBPA, 2005). These courses are housed in accounting departments, management departments, general business departments, and philosophy departments.

Maryland requires candidates sitting for the CPA examination to earn a baccalaureate or higher degree and to complete a total of 150 semester hours of coursework. Included in the 150 hours are 27 semester hours of accounting and 30 semester hours of general business. The Maryland educational requirements specify that three semester hours out of the 30 semester hours of general business include business ethics. Business ethics is defined as focusing on major ethical issues that businesses face. Examples of courses that fit the definition include Business Ethics, Ethics, and Professionalism in Accounting or Business. These courses are required to contain discussions on such things as corporate social responsibility, environmental concerns, confidentiality, advertising and hiring practices, and profit motive and the public good (MSBA, 2005).

Within the total hour requirement to sit for the CPA examination, Nebraska requires 30 semester hours in accounting and 36 semester hours in general business. Included in the 36 general business hours is a requirement for a three semester hour ethics course. The content and focus of the ethics course varies by institution. Examples of acceptable courses include Legal Environment of Business, Advanced Auditing, Ethics and Business, and General Ethics taught by faculty in the Philosophy Department.

Successful CPA examination candidates may be required to pass an ethics or rules examination before they are licensed. Presently 25 jurisdictions have this condition for licensure. The categories include the AICPA's Professional Ethics Examination, an examination on professional ethics, a rules examination, and a professional ethics course and examination. The breakdown is shown in Table 6.

As Table 6 illustrates, the majority of the states that require an ethics examination for initial licensure utilize the AICPA's Professional Ethics Examination. This examination focuses on the AICPA's Code of Professional Ethics. This code covers principles of professional responsibility, independence, integrity, objectivity, general standards of accounting principles, responsibilities to clients and colleagues, and other responsibilities and practices.

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TABLE 6
ETHICS REQUIREMENT FOR INITIAL LICENSURE

State Ethics Requirement	States
AICPA Professional Ethics Examination	Alaska, Delaware, Idaho, Maryland, Nebraska, New Hampshire, North Dakota, Ohio, Oklahoma, Oregon, Rhode Island, South Dakota, Tennessee, Utah, Washington
Professional Ethics Examination	California, Kansas, Montana, South Carolina, Wyoming
Rules Examination	Florida, Illinois, North Carolina, Utah, Wyoming
Professional Ethics Course and Examination	Colorado, Texas
Not Specified	Connecticut

The ethics requirements for renewal of the license are discussed previously in the section relating to general CPE requirements. That discussion indicated that 28 jurisdictions had some type of CPE ethics requirement for individuals renewing their license. The requirements vary from a minimum of two hours of ethics CPE every three years to four hours every two years.

CONCLUDING COMMENTS

The recent high-profile corporate scandals have placed increasing pressure on the accounting profession to recognize the importance of the ethical dimension necessary for securing public trust. The enactment of the Sarbanes-Oxley Act is tangible evidence of the importance that Congress places on the professional discharge of duties by accountants. State Boards of Accountancy have also acted by discussing and implementing increased ethics requirements for entry into and continued participation in the profession. NASBA attempted to take a leadership role in this by suggesting that candidates for the CPA examination be required to take formal ethics courses as part of their course of study. While this recommendation was ultimately not acted upon, it does reflect a changing mood in the profession. Texas, Maryland, and Nebraska have taken the lead in requiring coursework in ethics for CPA examination candidates. Whether other states will follow suit is yet to be seen.

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HSAs: A HEALTHY CHOICE FOR BUSINESSES

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Health care costs and health insurance premiums have been spiraling out of control for several years. The average cost of family premiums in 2004 was $829 a month or about $9,950 a year (Stafford, 2004). At the same time, employer health insurance premiums increased by 11.2 percent – nearly four times the rate of inflation (NCHC, 2005). Flexible spending arrangements (FSAs) and health reimbursement arrangements (HRAs) have been widely used for several years to help offset the high cost of medical expenses. However, the government has increased its efforts to help self-employed individuals and small businesses by creating medical savings accounts (MSAs) as part of the Health Insurance Probability and Accountability Act of 1996 (Moran, 2004).

In 1999, three health-care trends hindering a company's ability to control medical costs and maintain employee satisfaction were noted: (1) health plan premiums were forecasted to increase, (2) enrollments were predicted to be shifted from traditional HMOs to less managed PPOs with open access options, and (3) competition was expected to decline as health plans were merged into a few dominant players (Burnett, 1999). Congress responded to some of these concerns in 2003 by supplementing the MSAs with health savings accounts (HSAs) as part of the Medicare Prescription Drug Improvement and Modernization Act of 2003. HSAs have more potential benefits for individuals and businesses and are less restrictive than MSAs and other previously approved plans.

The purpose of this paper is to provide employers, practitioners, and educators with information regarding HSAs compared to other tax-favored health-care reimbursement plans. The first section will present background information leading to the creation of HSAs. This will be followed by a discussion of some basics of establishing an HSA including creating the trust account and eligibility requirements. The third section will explain contributions to and distributions from HSAs. The final section will explain the benefits and limitations of HSAs followed by concluding remarks.

Background

One of the oldest and most widely used arrangements designed to encourage individuals to save for incidental medical costs is the Flexible Spending Account (FSA) (Barker and O'Brian, 2004). Typically, an FSA is set up to reimburse out-of-pocket medical expenses with pre-tax salary-reduction funds through a cafeteria plan. Although these plans do provide some flexibility, FSAs were created with numerous regulations, and are often referred to as "use-it-or-lose-it" plans. This name is popular for FSAs because they do not have a carry-forward option. Thus, if employee contributions are not used, any balance will be lost at the end of a plan year. Because of this, individuals generally choose to contribute minimum amounts to FSAs. If any significant incidental medical costs are encountered there are often insufficient pretax funds set aside to cover them. With the risk of losing funds or having inadequate amounts available for medical expenses, FSAs may not be appealing to individuals who should be benefiting from them.

Similarly, HRAs are set up to reimburse a participant's medical expenses. HRAs are generally funded by the employer. Thus, employees do not run a risk of losing unused pre-

taxed salary deductions. However, like FSA plans, amounts do not have a carry-forward option and since the funds are employer provided, any amount not used is lost by an employee upon termination of his or her employment or at the end of any plan year. Both FSAs and HRAs were encumbered by numerous restrictions.

In 1996 congress passed the Health Insurance Portability and Accountability Act of 1996 (HIPAA) which created MSAs. HIPAA allowed MSAs to be created by an individual or an employer on behalf of an employee. Contributions to MSAs could be made by the self-employed individual or employer, they would roll over from year to year, and they were deductible and grew tax free. Eligible distributions from MSAs were not taxed. MSAs carried a requirement that for individuals to be eligible to create MSAs, they had to be covered by a high deductible health plan (HDHP). MSAs were burdened with several problems. First Congress limited the number of plans allowed to 75,000 and to self-employed individuals and employees in businesses that had 50 or fewer employees. (Moran, 2004) In addition, penalties for early withdrawal and tight contribution limitations made the plans unattractive to many employers and individuals.

In 2003, Congress created HSAs to improve many of the limitations contained in previous plans. Internal Revenue Code §223 defines an HSA as "a trust created or organized in the United States as a health savings account exclusively for the purposes of paying the qualified medical expenses of the account beneficiary." HSAs are similar to MSAs in that contributions are deductible and grow tax free, eligible distributions are not taxed, and balances in HSAs can be carried forward from year to year. HSAs are more attractive than MSAs in several aspects. Anyone can establish an HSA as long as the individual meets the eligibility requirements. Contributions can be made by the individual, the employer, or anyone else on behalf of the account beneficiary. Internal Revenue Service Publication 969 provides information on establishing an HSA, eligibility requirements, and rules for contributions and withdrawals.

BASICS OF ESTABLISHING AN HSA

Trust Account

HSAs must be set up as a tax-exempt trust or custodial account as permitted by IRS guidelines. The IRS has released model documents that trustees may use as trust or custodial agreements ("Health Savings Trust Account" Form 5305 – B, and "Health Savings Custodial Account" Form 5305 – C). No permission or authorization from the IRS is necessary to establish an HSA. Participants will need to work with a qualified HSA trustee, which can be a bank, an insurance company, or anyone already approved by the IRS to be a trustee of individual retirement arrangements (IRAs) or MSAs. The account is set up solely to pay qualified medical expenses.

Eligibility Requirements

Before an HSA can be created the eligibility status of an individual must be determined. The first eligibility requirement states that an individual has to be covered under a High Deductible Health Plan (HDHP). A self-only coverage plan qualifies as a HDHP if the yearly deductible is $1,000 or more and annual out-of-pocket expenses required to be paid do not exceed $5,000. A family coverage plan qualifies as a HDHP if the yearly deductible is $2,000 or more and annual out-of-pocket expenses required to be paid do not exceed $10,000. These limiitations are indexed for inflation. Out-of-pocket expenses are payments other than

premiums that must be paid for plan benefits, and includes both deductible amounts and co-payments. In order for a family coverage health plan to fully meet the deductible requirement, it must be a comprehensive deductible. That is, all expenses incurred by each individual covered goes towards meeting the family deductible.

An HDHP may provide preventive care benefits without a deductible or with a low deductible. Preventive care includes such items as periodic health evaluations such as annual physicals, routine prenatal and well child care, immunizations, tobacco cessation programs, obesity weight-loss programs, screening services including cancer, heart, infectious diseases, mental health, substance, obstetric and gynecological conditions, and vision and hearing disorders.

The second requirement relates to other medical coverage. If at anytime an individual becomes covered by a health plan that does not qualify as a HDHP, that individual is no longer eligible for an HSA. Individuals do not lose their eligibility status if, in addition to the HSA, they have coverage for any benefit provided by “permitted insurance.” Permitted insurance includes insurance relating to liabilities incurred under workers’ compensation law, tort liabilities, liabilities relating to ownership or use of property, insurance for a specified disease or illness, and insurance that provides a fixed payment for hospitalization. Individuals also do not lose eligibility if, in addition to an HDHP, they have coverage for accidents, disability, dental, vision, or long-term care.

The third eligibility requirement for establishing an HSA is the age of the individual. An individual is not eligible to establish an HSA if he or she is 65 years old or older. This age requirement coincides with the Medicare requirement. In order for an individual to be eligible for establishing an HSA, he or she must not be enrolled in Medicare. If an individual is eligible for Medicare, that does not change the eligibility status for an HSA. The only time this status is changed is when the individual is enrolled and receiving benefits from Medicare.

The last requirement for eligibility of establishing an HSA deals with dependency. A taxpayer who can be claimed as a dependent on another individual’s tax return can not establish an HSA.

CONTRIBUTIONS TO AND DISTRIBUTIONS FROM HSAs

As long as an individual is eligible, contributions of cash to an HSA account can be made by anyone on his or her behalf. All contributions (individual or employer) are reported on Form 8889 and filed with the individual’s Form 1040. Contributions made by the individual are tax deductible on his or her tax return whether or not deductions are itemized. These contributions are entered above adjusted gross income on the taxpayer’s Form 1040. Contributions made by an employer are made with pre-tax dollars and are not subject to employment taxes. Employer contributions are reported on the individual’s W-2 but are not treated as taxable income. Contributions made on behalf of the account beneficiary by another party are not taxed to the beneficiary. If at anytime an individual becomes ineligible to own an HSA, the account still exists, but contributions can no longer be made tax free.

An HSA account is restricted to an annual maximum contribution limit. This limit is determined by taking the lesser of 100% of the annual deductible under the HDHP, or the maximum deductible permitted, both adjusted for inflation. The maximum deductible permitted for a self-only HDHP in 2006 was $2,700 and $5,450 for a family HDHP. An individual must be eligible and have the same coverage all year to contribute the full amount. Any excess

contributions are not deductible. Maximum contribution limits for family HDHP are reduced for individuals when both spouses have separate plans. Employer funded excess contributions are generally taxable as other income and are subject to a six-percent excise tax. Maximum contribution limits are also reduced by any amounts contributed to an individual's MSAs. Excess contributions made by an individual can be avoided by withdrawing the excess before the due date of the tax return and reporting any earnings as other income.

After an account beneficiary reaches the age of 55, he or she can begin to catch-up contributions. In 2006 this catch-up contribution is $700 phasing up in $100 annual increments to $1,000 in 2009. These catch-up contributions increase the maximum annual contribution limit. Once an individual reaches the age of 65, he or she can no longer make contributions to an HSA. If at any time an eligible individual or one who is 65 or older has exceeded the allowable contributed amounts, the excess amounts are taxable and have a penalty of six percent.

Distributions from an HSA used to pay for or reimburse qualified medical expenses incurred by the account beneficiary, his or her spouse, or dependents are not subject to income tax. Qualified medical expenses are those expenses that would qualify for the itemized medical deduction. An individual cannot deduct amounts for qualified medical expenses as an itemized deduction that are equal to the tax-free distribution from an HSA. Most insurance costs are not qualified medical expenses for purposes of HSAs, but there are a few exceptions. They include long-term care insurance, COBRA premiums, premiums for health care coverage while receiving unemployment compensation, and health insurance premiums (other than Medicare supplemental policies) for individuals eligible for Medicare.

An individual may take a distribution from his or her HSA at any time, but there are consequences that arise for non-qualified medical expense distributions. Withdrawals for purposes other than qualified medical expenses are subject to income tax and, if distributed prior to age 65, death, or disability, are subject to an additional 10 percent excise tax. After an account beneficiary's death, disability, or reaching Medicare eligibility, distributions for purposes other than qualified medical expenses are not subject to the 10 percent excise tax, but the amounts are reported on the individual's tax return as other income.

Distributions for qualified medical expenses are not taxable, but are reported on Form 8889 and filed with an individual's Form 1040. As previously stated, excess distributions are reported on Form 8889 and also reported as other income on Form 1040. The taxpayer need not send any medical expense documentation with his or her tax return, but must keep records to verify that:

- The distributions were used to pay or reimburse only qualified medical expenses
- The qualified medical expense had not been paid or reimbursed by another source, and
- The medical expenses had not been used as an itemized deduction in any year.

BENEFITS AND LIMITATIONS OF HSAs

There are many benefits for individuals who own HSAs as well as for employers who contribute to their employees' HSAs. For individuals, one of the most attractive features is that the account is not a "use it or lose it" arrangement. In addition, since the individual is the sole owner, the account transfers from job to job, contributions are tax-free if they are within annual limits, the owner has control of the account allowing freedom in investment decisions, and earnings on the account can be withdrawn tax-free if used for qualified medical expenses.

Another benefit is that an HSA is held in an account for the benefit of the individual, his or her spouse, or children.

There are several retirement and estate planning considerations that make the HSA more attractive than other plans. With the carry-forward provision, individuals can set aside pre-tax dollars to pay for qualified medical expenses upon retirement. Once an individual reaches age 65, distributions may be made for any purpose without incurring the additional 10 percent excise tax. When an HSA owner dies, if the beneficiary is the spouse, the account becomes the account of the spouse. If the beneficiary is not the spouse, the account ceases to be an HSA. The beneficiary will not be limited by HSA rules, but the fair market value of the assets reduced by any qualified medical expenses paid by the beneficiary for the decedent within one year of death is taxed to the beneficiary in the year of death. If the HSA owner's estate is the beneficiary, the account value is included in the owner's final tax return.

Employers may also benefit from participating in HSAs contributions on behalf of their employees. Employer contributions are deductible as "employee benefit program" deductions. The pre-tax contributions are not subjected to withholding for income tax, FICA, or FUTA. Many employers will see the major advantage of the reduction in the monthly premiums paid for employees if they offer HDHP and contribute to the employees' HSAs (Basi, 2004).

Unfortunately, there are some limitations that both an individual and employer must consider in deciding whether to establish HSAs. One limitation an individual faces is once he or she reaches the age of 65, contributions may no longer be made to an HSA. Another limitation is that at any time an individual contributes more than the allowable amounts he or she will be accessed a six percent excise tax, and the excess amounts will be taxable. Like most other plans, distributions can only be used for qualified medical expenses if the individual wants to avoid including the distributions in gross income and, if under the age of 65, be assessed a 10 percent penalty.

Eleven states levy taxes on HSAs. Most of the 11 states do not allow tax-free contributions to the accounts, but all states allow participants to take out money tax-free (Anderson, 2005). Because HSA accounts are employee owned, any state tax burden falls on the employee rather than the employer (Anderson, 2005).

HSA rules for married individuals where the spouse also has medical coverage has produced some confusion. The IRS has provided some guidance in Revenue Ruling 2005-25. An individual does not lose his or her eligibility if a spouse is covered under a non-HDHP so long as the individual is not covered by the spouses' plan. When both spouses have family coverage HDHPs, complex rules apply to such situations. For example, if married couples are both covered by separate HDHPs or if one spouse enters the plan during the year, a complex set of rules must be followed to determine the maximum contribution limit. Also, individuals must file a Form 8889 if any activity transpired during the year (even if the only activity was an employer contribution.)

Contributions made by an individual to his or her HSA must be made in cash. If an individual does not anticipate having cash available, an HSA may not be the plan of choice. Some might argue that this is a severe drawback for lower-income taxpayers who are self-employed or whose employer does not adequately fund the HSA.

Employers will not encounter as many limitations as individuals, but there are several drawbacks to contributing to employee HSAs. Employer contributions must be comparable

(unless the contributions are made through a cafeteria plan) for all participating employees. Contributions are comparable if they are the same amount or the same percentage of the annual deductible limited under the HDHP covering the employees. Comparable participating employees are those that are covered by the employer's HDHP and are eligible to establish an HSA, have the same category of coverage (self-only or family), and have the same category of employment (part-time or full-time). If contributions are not comparable, the employer suffers a 35 percent excise tax on the amount contributed.

Employers face the risk of losing contributions made if an employee leaves the company since the owner of the account is not the employer. HSA provisions require immediate vesting and employee freedom to withdraw funds for non-medical purposes. Although these distributions will be taxable to the employee and possibly subject to the additional excise tax, employees may be more willing to use the account for purposes other than those intended by the employer. Finally, contributions to HSAs must be made only in cash. Employers cannot contribute assets such as stock or property.

CONCLUDING REMARKS

With the increase in health care costs and health care premiums, and the potential for these costs to continue to increase, employers and individuals are searching for ways to help reduce these costs. Those in favor of HSAs believe that, in the long run, HSAs will reduce an employer's health costs through the use of less costly HDHPs. Individuals who want more "consumer-directed" plans designed to let the owner select the timing and level of health expenditures will find HSAs a more attractive alternative to other tax-favored plans. A U.S. Chamber of Commerce survey found that almost three-quarters of the 1,000 employers surveyed were likely to offer an HSA in 2006 (Finkelstein, 2004).

On the other side, opponents believe that HSAs have the potential to undermine the current health care system. They also argue that the provision is simply another tax shelter for the wealthy and the number of un-insured Americans could increase if employers replace traditional health care coverage for workers with HSAs (Finkelstein, 2004.) If this is the case, there are many people taking advantage of the shelter. HSAs are expected to explode in 2006, with the number expected to more than quadruple, with at least 425,000 accounts already established (Gurchiek, 2005).

While the costs of medical care and health insurance premiums continue to rise, Congress has provided employers and individuals with alternatives to help mitigate some of the costs.

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