

## The Roth 401(k) Offers New and Exciting Opportunities

Roth IRAs have been popular since their introduction in 1998 because the earnings on funds invested in such accounts build up tax free, as opposed to merely tax deferred as in traditional IRAs. However, many people do not have Roth IRAs, either because their income is above the Roth IRA contribution limit (which generally ranges from \$110,000 to \$160,000, depending on filing status) or because they do not have any funds available to make Roth IRA contributions after funding their 401(k) or other retirement plans. Fortunately, this accessibility issue has dramatically improved.

The Economic Growth and Tax Relief Reconciliation Act of 2001 provides that beginning in 2006 employees who participate in a 401(k) plan are allowed to designate part (or all) of their contributions to the plan as Roth 401(k) contributions *as long as the plan has been amended to accept such contributions*. Note, however, that qualified plans are not required to do this. Unlike an employee's traditional 401(k) elective contributions, Roth 401(k) elective contributions are fully subject to tax in the year in which they are made (*i.e.*, contributions are post-tax). However, the earnings on such contributions escape being taxed if they are not withdrawn from the 401(k) plan before the later of (a) when the account owner reaches age 59½, becomes disabled, or dies; or (b) five years after the Roth 401(k) account is first funded.

For 401(k) plans *that have been amended* to allow Roth contributions, the plan must track these contributions and their related earnings in an account that is separate from: (1) the

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## Considering Purchasing a Hybrid Vehicle?

As discussed in our *Year-End Tax Planning Guide for 2005*, on August 8, 2005, the Energy Tax Incentives Act of 2005 (the "Energy Act") was signed into law. Although it contained \$14.5 billion in tax incentives designed to improve energy production, transportation and efficiency, its provisions were not effective until 2006 and included tax credits for individuals who purchase vehicles *powered by alternative fuels*.

The Energy Act replaced the \$2,000 above-the-line deduction previously available for the purchase of hybrid vehicles through December 31, 2005, with a new qualified hybrid motor vehicle tax credit for qualified hybrid passenger automobiles and light trucks purchased after that date. A qualified vehicle may not weigh more than 8,500 pounds, must be purchased before a statutorily-defined number of qualified vehicles are purchased and must meet certain fuel-economy requirements.

In addition, the maximum credit is \$3,400 and it will expire after December 31, 2010. The amount of the credit cannot reduce your federal income tax liability below the alternative minimum tax (AMT) amount. Therefore, if you are already subject to the AMT, you will receive no benefit from this credit. If you are unsure of your AMT exposure and are considering an alternative fuel vehicle purchase, please feel free to give us a call.

The Internal Revenue Service has acknowledged the certifications by Ford Motor Company and by Toyota Motor Sales U.S.A. Inc. that several of their 2006 and 2007 vehicles (and a Toyota 2005 model year vehicle) qualify for the hybrid tax

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# The Roth 401(k) Offers New and Exciting Opportunities

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employee's regular 401(k) contributions, (2) any employer matching contributions, (3) any forfeitures allocated to the employee, and (4) the earnings thereon. Accordingly, all that will be in an employee's Roth 401(k) account will be the employee's own after-tax Roth contributions and the related earnings (any matching contributions made by an employer would be part of the employee's regular 401(k) account). Unfortunately, there is currently no provision for converting existing regular 401(k) accounts into Roth 401(k) accounts. Keep in mind that this separate accounting requirement adds another layer of complexity to the qualified plan, and also increases the recordkeeping and compliance costs of the employer. Furthermore, and subject to a plan allowing it, employees may split their annual 401(k) contribution limit between regular (pretax) and Roth (post-tax) contributions, in any manner they choose, or they may make only regular or only Roth contributions.

## Observation

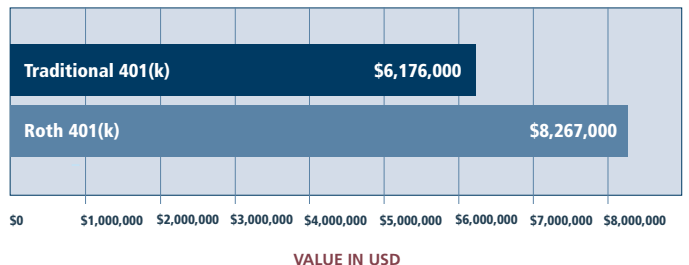
In general, traditional 401(k) pretax contributions tend to make more sense for employees who expect their marginal tax bracket to fall in the future. Roth 401(k) post-tax contributions are more likely to be the right choice for employees who expect their marginal tax bracket to increase, or at least stay the same, in the future.

A significant advantage of Roth 401(k) accounts over Roth IRAs is that the annual contribution limit is higher for Roth 401(k) accounts (\$15,000 for 2006, increased to \$20,000 for individuals who will be at least 50 by the end of 2006) than for Roth IRAs (\$4,000 for 2006, increased to \$5,000 for individuals who will be at least 50 by the end of 2006). Also, there is no income phaseout limitation for making Roth 401(k) contributions (although the annual limits on employee contributions to 401(k) plans, including Roth 401(k) plans, apply, and the standard 401(k) nondiscrimination rules also apply, which can limit certain higher-income taxpayers' ability to make contributions – just as the rules currently do for regular contributions). However, Roth 401(k) contributions are post-tax, so adjusted gross income is not reduced, which may cause the reduction of deductions or credits. As the saying goes, you may want to “crunch the numbers.”

We have developed a comprehensive proprietary model that allows us to quantify the difference in value between traditional 401(k) and Roth 401(k) accounts. This model allows us to

## SCENARIO ONE

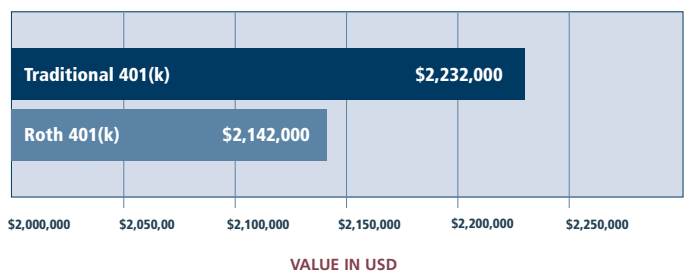
### ROTH VS. TRADITIONAL 401(K) - Starting at age 25



\* Contributions starting at age 25, 15% current income tax rate, 35% income tax rate at distribution. Assumes a 9% annual rate of return, maximum contribution made on an annual basis through age 69, and a total distribution at age 70.

## SCENARIO TWO

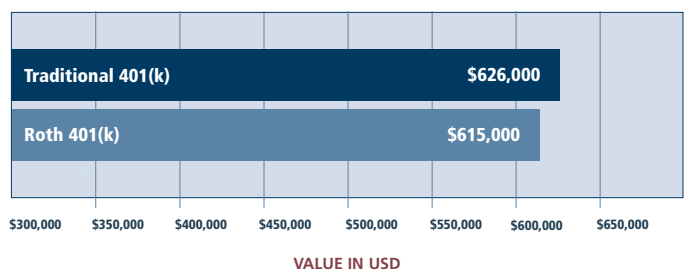
### ROTH VS. TRADITIONAL 401(K) - Starting at age 40



\* Contributions starting at age 40, 35% current income tax rate, 15% income tax rate at distribution. Assumes a 9% annual rate of return, maximum contribution made on an annual basis through age 69, and a total distribution at age 70.

## SCENARIO THREE

### ROTH VS. TRADITIONAL 401(K) - Starting at age 55



\* Contributions starting at age 55, 35% current income tax rate, 25% income tax rate at distribution. Assumes a 9% annual rate of return, maximum contribution made on an annual basis through age 69, and a total distribution at age 70.

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determine, for virtually any person, at any age, in any current (or retirement) federal tax bracket, and for any amount of annual 401(k) contributions, the projected difference in the two types of 401(k) accounts. Whether you are 25 and just getting started making 401(k) contributions, or 55 and contemplating making contributions for just a few years, our model can quantify the financial difference between the two alternatives. The difference may be much greater (or far smaller) than you envision, but having information on which to make an informed decision is the key.

The accompanying graphs illustrate the after-tax differences between making Roth 401(k) and traditional 401(k) contributions under three different scenarios.

The graphs are not intended to cover every possible pattern of contributions or distributions, changes in current or retirement marginal federal income tax rates, or changes in the rate of return on the amounts contributed, and they are not intended to

provide legal or tax advice. They are intended to be used as a guide in illustrating the range of potential differences in the net values of Roth 401(k) and traditional 401(k) accounts.

As the graphs illustrate, in the first scenario the Roth 401(k) net value is significantly higher than the traditional 401(k) net value; in the second scenario the traditional 401(k) net value is significantly higher than the Roth 401(k) net value; and in the third scenario the two net values are not significantly different.

Since there is no crystal ball to look into to determine what will happen to federal income tax rates in the future, the most prudent approach is to view your alternatives using current federal law and to modify any decision you make based on future changes in the law.

We would be delighted to perform the Roth 401(k) vs. traditional 401(k) analysis for you. Feel free to contact us for an analysis specific to your own situation. |||

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## Considering Purchasing a Hybrid Vehicle?

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credit enacted by the Energy Act. The hybrid vehicle certifications recently acknowledged by the Service and their credit amounts are:

2005 Toyota Prius	\$3,150
2006 Ford Escape Hybrid Front WD	\$2,600
2006 Lexus RX400h 4WD	\$2,200
2006 Toyota Highlander 4WD Hybrid	\$2,600
2006 Ford Escape Hybrid 4WD	\$1,950
2006 Toyota Highlander 2WD Hybrid	\$2,600
2006 Mercury Mariner Hybrid 4WD	\$1,950
2006 Lexus RX400h 2WD	\$2,200
2006 Toyota Prius	\$3,150
2007 Toyota Camry Hybrid	\$2,600
2007 Lexus GS 450h	\$1,550

If you seek this credit, you should consider buying early since the full credit is available only for a limited time. As additional vehicles are manufactured that qualify for the hybrid tax credit, the IRS will acknowledge their certifications.

In general, hybrid vehicles have higher price tags than conventional fuel vehicles. Accordingly, you should consider whether the combination of gasoline savings and potential tax credits will allow you to recoup the hybrid's higher price. The uncertainty in predicting future gas prices, the difficulty in estimating the number of miles the car will be driven, the possibility that additional tax incentives for hybrids will be allowed and the resale value of a hybrid vehicle also affect the value of a hybrid.

Furthermore, since hybrid vehicles use expensive nickel-metal hydride battery packs that do not have unlimited lives, the battery replacement expense, which may be \$3,000 or more, must also be considered. And as indicated above, the full credit for hybrid vehicles is available only for a limited time, the credit does not apply against the AMT and any unused credit cannot be carried over to another tax year.

Based on these factors, it is clear that the decision to purchase a hybrid vehicle is not totally subject to objective, quantitative analysis, since these and other uncertainties exist. Please do not hesitate to contact us if you would like to discuss your particular options with regard to the new hybrid vehicle tax credit. |||

# The Simplified Employee Pension (SEP), a Roth 401(k) Alternative

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As you may be aware, the Job Creation and Worker Assistance Act of 2002 provided changes in simplified employee pension (SEP) plans that made the contribution limits for them equal to the limits for defined contribution plans (profit-sharing plans, 401(k) plans, etc.).

Thanks to these changes, generous amounts can be contributed to SEPs set up for the benefit of small business owners who earn healthy incomes from their ventures. An additional bonus with SEPs is that a newly formed SEP is also: (1) incredibly easy to establish (unlike other types of retirement plans), and (2) a powerful *retroactive* tax planning tool (unlike other types of retirement plans). In fact, some people suggest that SEPs are the “no-brainer” first choice for most high-income small business owners who have not yet set up tax-advantaged retirement plans.

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## Setting Up a SEP

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A SEP is generally very easy to establish. SEPs are available to self-employed individuals (sole proprietors and owners of single-member LLCs treated as sole proprietorships), partnerships (including multimember LLCs treated as partnerships) and corporate employers alike. Establishing a SEP merely entails completing and signing Form 5305-SEP (Simplified Employee Pension-Individual Retirement Accounts Contribution Agreement). In addition, and as contrasted with defined contribution plans, there is *no requirement* to file annual retirement reports for a SEP.

Since the SEP can be established as late as the extended due date of the self-employed person’s or employer’s tax return for the taxable year for which the SEP is to first apply, a SEP can be considered a powerful retroactive tax planning tool. For example, if you as a sole proprietor (or as a partnership or corporation) have extended your calendar year 2005 income tax return to October 16, 2006, you can establish a SEP as late as that date, make the initial contribution and claim a potentially hefty deduction on your 2005 return. In general, other types of retirement plans must be in existence by the end of the year for which the plan is to first apply.

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## Funding and Participation Requirements

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The first step in funding a SEP is to set up an IRA for each eligible participant with a qualified IRA trustee (*e.g.*, a bank, insurance company, mutual fund company or brokerage

company). The self-employed individual or employer then makes contributions directly to each participant’s IRA.

If the business has one or more employees (other than the owner), the Internal Revenue Code defines an eligible employee for SEP participation purposes as one who has:

1. Attained age 21;
2. Performed any services for the employer during at least three of the preceding five years; and
3. Received at least \$450 in compensation (this is the inflation adjusted amount for both 2005 and 2006).

The employer is always free to establish less restrictive eligibility requirements. All eligible employees must participate in the plan, including ones who die or quit during the year. If an eligible employee cannot be located or is unable or unwilling to set up an IRA, the employer can execute the necessary paperwork to establish an IRA on behalf of the employee in order to prevent the SEP from being disqualified.

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## Annual Contribution Limits

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For 2005, the maximum contribution to a SEP account set up for an employee (including a sole shareholder-employee of the sponsoring corporation) is the lesser of: (1) 25% of the participant’s compensation (\$210,000 maximum for 2005), or (2) \$42,000. For 2006, the \$210,000 limit on compensation is increased to \$220,000 and the \$42,000 maximum contribution is increased to \$44,000. Those 2005 contribution limits are much greater than the 2005 contribution limits for IRA or 401(k) accounts, which are \$4,500 and \$18,000, respectively.

For purposes of calculating the maximum contribution to a self-employed individual’s SEP account, compensation is defined as: (1) self-employment income from the business that established the SEP, minus (2) the above-the-line deduction for 50% of self-employment tax, minus (3) the individual’s deductible SEP contribution. This formula results in an effective maximum contribution percentage of 20%, and the contribution caps of \$42,000 for 2005 and \$44,000 for 2006 still apply.

For example, John, the owner of a single-member LLC with no employees, extended his 2005 return until October 16, 2006. On or before that date, he establishes a SEP for himself. His 2005 self-employment earnings from the LLC are \$200,000 and his deduction for 50% of his self-employment tax is approximately

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\$8,300. John's maximum SEP contribution for 2005, therefore, is \$38,340  $(\$200,000 - \$8,300) \times 20\%$ .

John can contribute that amount on or before October 16, 2006, and claim a corresponding deduction on his 2005 return. This is retroactive tax planning at its finest!

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### Conclusion

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In some areas there may be disadvantages to establishing a SEP (as opposed to some other type of qualified plan). For example, if the business has employees other than the owner, those employees will often have to be covered with contributions made using the same percentage of compensation as for the owner. Furthermore, any contributions to employee accounts are immediately 100% vested, so that an employee may take all of the contributions made on his or her behalf and leave, compared

with other qualified plans in which vesting requirements are generally imposed, which generally reduce the amount of employer contributions that can be taken. In addition, even when the SEP is established by a self-employed individual with no other employees, a defined benefit pension plan may permit an older individual to make bigger deductible contributions than the SEP does.

We believe you should probably view SEPs as the retirement plan equivalent of LLCs. In other words, a small business owner should generally evaluate the wisdom of establishing a SEP before considering other retirement plan alternatives, just as he or she should generally evaluate the wisdom of forming an LLC before considering other business entity alternatives.

If you have any questions about SEPs, or the Roth 401(k) plans discussed previously, or about retirement savings strategies, please contact us. |||

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## Recent Developments in the Florida Intangibles Tax Area

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We have not addressed the personal property tax imposed by various Pennsylvania counties since the summer of 2000, when we discussed the case of *Annenberg v. Commonwealth of Pennsylvania*, but recent developments in Florida, which we have been monitoring, have shown that personal property, or intangibles, tax issues are not unique to Pennsylvania.

A repeal of the Florida Intangibles Tax (an annual tax of .0005 on intangibles based on values at January 1) on stocks, bonds and other intangible property, a levy that Governor Jeb Bush called "insidious," was passed by the Florida Senate on April 26, 2006, and is expected to be signed into law sometime in June. (At press time, it had not yet been signed into law, but all reports indicate that Governor Bush will sign it, likely in the very near future.) The effective date of the repeal is January 1, 2007, so returns for 2006 based upon the January 1, 2006, valuation date are still due this spring. Some had hoped that the repeal would be retroactive to January 1, 2006, but that was not reflected in the legislation that will be effective once it has been signed by Governor Bush.

The intangibles tax rate has been reduced several times since 1999 and was again reduced to 0.5 mills per dollar (from 1 mill per

dollar) effective January 1, 2006. Governor Bush claims that the elimination of this tax will benefit an estimated 300,000 taxpayers.

The Republican-sponsored \$130.6 million intangibles tax repeal cleared the Senate 30-9, with the nine opposing votes cast by Democrats. Five other Democrats, however, crossed party lines to vote for the repeal. "The insidious intangibles tax is no longer with us, which is great," Bush said.

Democratic opponents contended the tax break would benefit some of Florida's wealthiest citizens, shift the burden to other taxpayers and deprive the state of money for such services as food supplements for developmentally disabled children.

Democratic Senator Steve Geller called the repeal the "No Millionaire Left Behind Tax Act" and Robin Hood in reverse. He noted that retirement savings such as 401(k) accounts and money in banks are exempt from the tax. Republican supporters argued that the wealthiest investors do not pay the tax because they temporarily move their assets outside the state at year's end. "Those who have the means will walk around it," said Republican Senator Jeff Atwater. "It is a matter of fairness."

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Perhaps more interesting than the repeal of the intangibles tax is the fact that Florida has consistently moved in the direction of reducing or eliminating many of the taxes that residents of other states routinely pay. The federal Economic Growth and Tax Relief Reconciliation Act of 2001 effectively eliminated Florida's estate tax; the state does not have an individual income tax; and the Florida legislature often passes sales tax

holidays for items such as computers and back-to-school clothing and supplies. In fact, it passed a nine-day, \$39 million back-to-school sales tax break the same day that it repealed the intangibles tax. It seems clear that Florida continues to make serious efforts to become the most taxpayer-friendly state in the Union. Walt Disney would be proud. |||

## Deciding When to Begin Receiving Social Security Benefits

For many Americans, their monthly Social Security check represents a significant portion of their annual retirement income. According to some studies, even the wealthiest 40% of retirees depend on Social Security for up to a third of their retirement income, on average.

Given the importance of this income stream, it is important to take great care in deciding when to begin receiving benefits. The benefit that you receive every month will depend to a large extent on whether you apply for benefits at age 62, at your full retirement age (65 to 67, depending on the year you were born), or at age 70.

Your monthly benefit at age 62 could be as much as 25% less than your "full" benefit at age 66, but delaying your first payment until age 70 could result in your monthly benefit being up to 40%

higher than your "full" benefit. Furthermore, these differences apply to all of your lifetime payments.

If you knew for certain how long you would live, and if your only concern was to receive as much as possible from Social Security during your lifetime, deciding when to begin receiving payments would be quite simple.

The following table illustrates the benefits you would receive based on three different starting ages. The amounts assume that the individual receiving the benefits had an annual income, while working, of \$60,000 and qualified for full benefits at age 66 in 2017. The amounts are in constant 2005 dollars and do not include potential earnings from reinvestment. Actual income will include increases in benefits based on inflation.

If you begin collecting Social Security benefits at	And your monthly benefit is	Benefits received by age 75	Benefits received by age 80	Benefits received by age 85	Benefits received by age 90
Age 62	\$1,200	\$187,200	\$259,200	\$331,200	\$403,200
Age 66	\$1,600	\$172,800	\$268,800	\$364,800	\$460,800
Age 70	\$2,200	\$132,000	\$264,000	\$396,000	\$528,000

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As the table indicates, postponing Social Security benefits can pay off – in the long run. As it also indicates, if you knew you would not live past age 75 you would want to begin receiving your benefits at age 62. On the other hand, if you assumed that you would live until at least age 80, you might consider waiting until full retirement age (65 to 67, depending on the year you were born). The advantage of deferring your collection of benefits until age 70 eventually exceeds the advantage of starting at age 62, but not until sometime between ages 80 and 85.

Since you do not know how long you will live, you may want to rely on some statistical information. In a 2005 report, the National Center for Health Statistics said that, on average, Americans who are 65 years old live to about age 83 (age 84.5 for women and age

81.6 for men). In addition, considering your current state of health and your family medical history may also help you estimate how long you will live. But these, obviously, are not definite indicators as to when you should start collecting your Social Security benefits.

We have to admit that there is no ideal age at which to begin collecting. It varies from person to person and is usually apparent only in hindsight. What we can say is that the most prudent approach is to base your decision on whether you need extra income at age 62 or thereafter, and on the state of your health.

Please do not hesitate to contact us if you have any questions regarding making a decision as to when to begin receiving Social Security benefits. |||

## Tax Accounting Group News

**Michael A. Gillen** appeared on a variety of television and radio programs throughout fourth quarter 2005 and first quarter 2006 providing tax preparation tips for individuals and small businesses. Appearances included *Comcast Newsmakers*, *CN8 Money Matters* and the “Executive Leaders” radio program on the financial news and information station WWDB 860 AM.

**Steven M. Packer** was recognized by and presented with a certificate from the Greater Philadelphia Chamber of Commerce for active participation on the Chamber Ambassador Committee during its inaugural year. The mission of the Greater Philadelphia Chamber of Commerce Ambassador Program is to engage, inform and indoctrinate current and incoming Chamber members into the regional business community, and to grow and stimulate business opportunities within the region.

**Bruce Rogers** was elected to serve on the Executive Committee of the Greater Philadelphia Chapter of the Pennsylvania Institute of Certified Public Accountants at its annual meeting for a two-year term commencing May 1, 2006. The PICPA is the second-oldest and fifth-largest state CPA society in the country.

**David Rothschild** spoke on February 16, 2006, to the West Chester Exchange Club at the West Chester Country Club about individual income tax changes for 2005 and 2006. The Exchange Club of West Chester is a local charity for abused children. The group raises funds for the West Chester Family Center and participates in other charitable events.

## About Duane Morris

Duane Morris LLP, among the 100 largest law firms in the United States, is a full-service firm of more than 600 lawyers. In addition to legal services, Duane Morris has independent affiliates employing approximately 100 professionals engaged

in other disciplines, such as the Tax Accounting Group. With offices in major markets, and as part of an international network of independent law firms, Duane Morris represents clients across the nation and around the world. |||

## About the Tax Accounting Group

The Tax Accounting Group, one of the largest groups of its kind in any law firm, has an active and diverse practice with more than 60 service lines in more than 45 industries, serving clients in 43 states and eight foreign countries. The Group's certified public accountants, certified fraud examiners, financial consultants and advisors provide a broad range of cost-effective tax preparation, planning and consulting services as well as accounting, financial and management advisory services to individuals, corporations, partnerships, estates and trusts, and nonprofit organizations. The Group also provides an

array of litigation consulting services to numerous lawyers and law firms representing clients in regulatory and transactional matters and throughout various stages of litigation. Consulting services include, but are not limited to, case assessment and strategy development; asset recovery investigation and locator services; damage assessment and measurement; marital disputes; forensic and investigative accounting; fraud and embezzlement detection; and civil and criminal tax controversies. |||

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OF DUANE MORRIS LLP

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