

CPA CLIENT

HENDERSON HUTCHERSON & McCULLOUGH, PLLC

Business Consultants

1000 RIVERFRONT PARKWAY

CHATTANOOGA, TENNESSEE 37402-2103

Email: CPA@HHMCPAS.COM

Internet: WWW.HHMCPAS.COM

OCTOBER / NOVEMBER / DECEMBER 2005

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Divorce Is Bad Enough; Don't Add Tax and Financial Planning Errors into the Mix, Part I

With upwards of 51% of marriages in the United States ending in divorce, you should count your blessings if your marriage stays the course. For those that do not, however, there are critical tax and financial planning considerations to bear in mind before, during, and after a marital dissolution.

Although unpleasant to think about, divorce requires careful planning with your CPA to help mitigate some of the negative financial side effects. With the right strategy, parties to a divorce can avoid many common tax and financial planning errors.

Support payments

Child support. Child support payments are neither taxable to the receiving spouse nor deductible by the spouse who makes the payments. In other words, child support payments are—for tax purposes—non-events.

Alimony. Alimony is a completely different matter, and the distinction between alimony and child support payments is critical for tax purposes. Alimony is deductible to the payor and income to the payee. For example, if a former wife pays \$1,000 alimony per month to her ex-husband, she can deduct that amount from gross income "above the line" on her tax return, while he must report the entire \$12,000 (\$1,000 times 12 months) in that year's return.

The Tax Code clearly defines which payments are treated as taxable alimony, versus nontaxable child support.

Various court cases further refine this definition. In summary, payments will be considered to be alimony so long as they are (1) made for a defined period of time as embodied in a divorce or separation instrument (that is, judicial decree of divorce or separate maintenance or a decree of temporary support); and (2) will cease at the recipient's death. Our office can ascertain that these and other requirements are met, and we can talk to you about the special circumstance of recapture of spousal support.

Alimony trusts. Sometimes couples will agree to create an alimony trust. The paying spouse places funds into a trust maintained for the benefit of the receiving spouse and administered by an independent trustee. Under an alimony trust, the recipient spouse's taxable support income is composed only of the portion of the payments equal to the trust's taxable income; however, the paying spouse cannot take an alimony deduction.

Property settlements

Special rules govern transfers of property between spouses—divorcing or otherwise; other rules are specific to property settlements set forth in divorce decrees signed by a judge. Our office can help you get the best tax treatment for property that is transferred between divorcing or divorced couples.

Among the many rules and special considerations that should be taken into account, you should pay special

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Divorce Is Bad Enough; Don't Add Tax and Financial Planning Errors into the Mix, Part I

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attention to life insurance, the family house(s), retirement benefits, gifts, business ownership, and all other property that makes up what is typically referred to as the "marital estate." Some states follow community property rules, whereas others are governed by common law property rules. Under either system, our office can help you understand the tax consequences of the rules and plan your property settlement, before the final divorce decree is finalized. Time is an important factor in divorce tax planning, and you should consult with our office as early in the process as possible.

Tax-deductible attorney's fees

The majority of divorcing couples turn to lawyers when seeking a divorce. Legal fees grow in direct proportion with the complexity of the case and the animosity between the partners, not to mention the attorney's years of experience and expertise. The "good news" is that meetings concerning certain issues with your divorce lawyer may be tax-deductible.

You may deduct attorney's fees that are associated with (1) tax planning, (2) obtaining taxable income, and (3) securing an interest in a qualified retirement plan. Remember to ask your attorney to itemize billing to indicate which fees are related to these items. To reap the benefit, you must itemize your deductions, and these fees, along with other "miscellaneous itemized deductions," must exceed 2% of your adjusted gross income. Our office will help you determine whether you can benefit from this deduction and how to prorate the fees for the (often) years spent obtaining a final divorce decree.

Another interesting caveat in tax law planning for divorce: You might be

able to add the costs associated with nondeductible attorney's fees to the capital basis of the property you receive in the divorce (particularly the marital home), which will reduce your potentially taxable gain when you sell the property — an unfortunate event that tends to follow divorce.

Filing status and dependency exemptions

If children are involved, the issue of filing status becomes important, as do the issues of who can use dependency exemptions, deductions, and the child tax credit.

Dependency exemption. Divorce settlements typically designate which parent receives a dependency exemption but, if yours does not, tax law gives the exemption to the parent who has physical custody for more days of the calendar year. For cases in which this number is even between the two parents, our office can talk to you about determining the exemption.

This issue is important because the dependency exemption (\$3,200 for 2005) is useless to a parent with zero income or to a parent with a very high income level. As a rule of thumb, having zero income as well as income too low to qualify equates to zero deduction; and exemptions are phased out entirely at very high income levels. If you are filing as head of household and receive under a certain threshold level of adjusted gross income (AGI) for the year, the exemption would be wasted on you. On the other end of the spectrum, if your AGI for 2005 exceeds \$182,450 as head of household, your personal exemptions are phased out by 2% for every \$2,500 of income in excess of these limits.

Your filing status. If you have only one child, then only one of you may

claim the head-of-household filing status. You and your ex-spouse may both claim this status if you have two or more children and some live mostly with you and some mostly with your ex-spouse.

In the next issue of CPA Client Tax Letter, we will discuss the marital home, the treatment of retirement benefits, and gift and estate tax issues that arise in divorce.

2005 Year-End Tax Planning Ideas for Businesses

Regardless of the structure of your business — limited liability corporation (LLC), C or S corporation, sole proprietorship, or partnership — you need to plan carefully during the last three months of the year to minimize your 2005 tax bill. The steps you take now will directly affect your after-tax profit margin. Remember, each situation is unique, and these few tips are intended to give general information. A myriad of year-end planning choices and considerations are available. Our CPAs would be happy to speak with you about your specific business tax planning needs.

Section 179 expensing deduction

The Tax Code allows you to expense up to \$105,000 of qualified fixed assets for 2005, rather than depreciating them over several years. This deduction is limited to personal property used in your business; it is not extended to real property. However, you cannot expense more than the taxable income generated by your active trade or business activities. The expensing

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2005 Year-End Tax Planning *continued from page 2* — deduction is reduced dollar-for-dollar if your total qualifying business property purchases rise above \$420,000, and it is eliminated if they reach \$525,000.

If you determine that your total asset purchases this year may exceed the \$105,000 limit, call our office to discuss the possibility of holding off on making additional business purchases until 2006. We can determine whether your business will be eligible to use the \$105,000 expensing deduction next year.

If you are thinking about purchasing off-the-shelf computer software, you must act soon. Software purchases are eligible for expensing under Section 179, but only through 2007.

NOLs

If your business had a net operating loss (NOL) in 2004 — meaning your expenses exceeded your business income — you can generally “carry forward” these net losses and deduct them in 2005 or they can be “carried back” for two years. This carryback period opens the door for tax planning, in terms of timing the receipt of refunds and offsetting future income (for up to 20 years). You can also elect to give up the carryback period.

NOL deductions are directly affected by the type of business you have; C corporations are governed by different rules

from unincorporated businesses and S corporations. Our CPAs are well-versed in these different rules and can plan effectively for end-of-year NOL decisions.

Domestic production activities deduction

Is your business involved in domestic manufacturing, engineering, construction, eligible production activities, or architectural services that are related to construction? Regardless of whether your business is incorporated, you may be eligible for a 2005 deduction of 3% of the lesser of your (1) “qualified production activities” income; or (2) taxable income.

The rules surrounding this deduction are as intricate as they are complex. Our office can talk to you about your eligibility, deduction limits, and other factors affecting this new deduction’s impact on your business tax liability for 2005.

Self-employed health insurance deduction

For 2005, self-employed individuals may deduct all of their health insurance premiums as an “above-the-line” deduction on Form 1040. Qualified individuals include sole proprietors, more-than-2%-shareholder-employees of S corporations, and those partners and LLC members who perform services for the business. You are entitled to deduct as a business expense 100% of health insurance premiums for yourself, your spouse, and your dependents.

2005 Year-End Tax Planning Ideas for Individuals

We are available to discuss numerous tips on end-of-year planning — including, but not limited to, alternative minimum tax (AMT) planning, retirement plan and medical savings vehicles planning, gifting, and timing of deductions. Here are a few additional ideas to start thinking about:

Withholding taxes

Check your pay stubs or with your employer to see that you have paid enough in estimated taxes this year — either through withholding or estimat-

ed tax payments — to avoid penalties for underpayment. You can make up for any anticipated shortfalls before December 31 by increasing the amount withheld from your paycheck or by making an additional estimated payment. We can help you decide how best to avoid penalties for underpayment of estimated taxes.

Make charitable donations

As we discussed in the September edition of the *CPA Client Bulletin*, various rules apply to the limits and reporting requirements for donations to charities, depending on the type and value of donation made.

You can lower your tax bill by donating to charities, but only if you itemize. You may also be able to get a bigger “bang for your buck” by donating appreciated stock. You may deduct the full market value of the stock and avoid paying tax on the capital gains.

Offset your gains and losses

Now is a good time to examine your portfolio for offsetting losses. It’s also an excellent time to review the holding periods of your investments and determine which investments to sell. You may be able to rebalance your portfolio without tax consequences by redirecting future investing activity.

New Energy Bill Includes Good Reasons to “Go Green”

In August, President Bush signed into law the Energy Tax Incentives Act of 2005 (also known as the Energy Policy Act of 2005), which includes a \$14.5 billion tax component. Although the majority of the tax law provisions directly pertain to energy companies, they also provide tax incentives geared

at individuals and small businesses.

For individuals. To name a few, the law provides homeowners a tax credit of up to a lifetime limit of \$500 for money spent on energy improvements made to your own home. This lifetime limit applies to everyone, regardless of how much income — and tax bracket — they earn. For example, you can install a high-efficiency central air con-

ditioner, energy-saving windows, or an “energy smart” water heater, among many other items, and be rewarded for your choice with a tax credit.

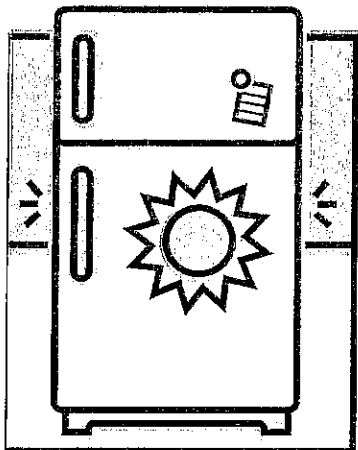
And you’re in luck if you’ve thought about using alternative energies for your home. Under the new law, you are eligible for a 30% tax credit, or up to \$2,000, in reward for purchasing a solar-powered water heater or

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New Energy Bill

continued from page 3 — any fuel cell equipment for your primary residence. There are also credits for alternative motor vehicles and using certain types of fuel. Additionally, there is a credit for the construction of a new energy-efficient home and another lesser one for certain energy efficiency improvements made to your existing home.

These perks are of limited duration: To take advantage of the energy bill tax breaks for your home, you must make the improvements between January 1, 2006 and December 31, 2007. Otherwise, you will have lost your window of opportunity.



Tax breaks for businesses. If you are a manufacturer of energy-efficient appliances, such as clothes washers, dryers, or refrigerators, you will be eligible for a tax credit in ranges such as: \$100 per washer or dishwasher and \$75, \$125, or \$175 for a refrigerator, depending on the energy savings it provides. The law also includes a business solar investment tax credit and a deduction for energy-efficient commercial buildings.

Daylight Saving Time

A particularly interesting feature of the new law is that it expands daylight

saving time (DST) by a total of one month to promote energy conservation. Starting in 2007, DST will begin three weeks earlier, on the second Sunday in March, and will be extended by one week to the first Sunday in November (resulting in more daylight trick or treating time). In theory, we will consume less energy in terms of artificial lighting in the daylight. Not every state follows DST — be sure to check with local authorities to see how this change may affect you at home and while traveling.

Another bill that was signed into law the same month is the Safe, Accountable, Flexible, and Efficient Transportation Equity Act of 2005. The next edition of *CPA Client Tax Letter* will feature an article explaining, among other things, how the two new laws work together to supplant and enhance previous legislation on tax and other breaks for hybrid energy vehicles.

Keeping a Step Ahead of the AMT

In foreseeable tax years, the alternative minimum tax (AMT) will creep up on an alarmingly high number of individual taxpayers. In 2004 alone, the AMT became something of “a mighty tax,” ensnaring some 3.5 million individual taxpayers, many of whom are characterized as middle class and lower-middle income individuals. By 2010, the AMT is expected to affect 33 million tax-paying units, including nine out of ten taxpayers with an adjusted gross income of \$100,000 or more.

The AMT was created in 1969 to ensure that all taxpayers pay at least a minimum tax because, under the climate at the time, some high-income taxpayers were able to significantly reduce or eliminate their regular tax by taking advantage of tax laws. In other words, the AMT was designed to disallow millionaires from escaping their fair share of taxes by limiting deductions from income in computing federal tax liabilities. Unfortunately, 36 years of inflation have occurred since the AMT's inception without any corresponding adjustments to limit its impact.

The AMT eliminates many common deductions or credits that benefit families — such as the dependent exemption, the mortgage interest deduction, and the deduction for state and local taxes — resulting in a much higher taxable income and an often considerably higher tax bill. The AMT becomes due only if it exceeds your regular income tax liability. Our

office will calculate your regular tax and then perform a parallel AMT calculation without the disallowed deductions and making certain other adjustments.

AMT triggers

There are almost as many triggers for AMT liability as there are deductions and credits that reduce regular tax liability. Listing them all would amount to reciting nearly the entire Tax Code.

Suffice it to say, among the countless triggers, several loom largest. They include real property, state income, and personal property tax deductions; medical deductions; deduction of home mortgage interest; personal exemptions; the standard deduction; and miscellaneous itemized deductions.

Careful AMT planning

Daunting as it might be, it is not impossible to try to keep a step ahead of the AMT. At the very least, you can mitigate its effects. Planning, especially when it concerns AMT mitigation, is a multifaceted task.

And when it comes to AMT planning, your best tool is your CPA. That's why you should call us — any time throughout the year — to discuss the best ways to keep a step ahead of the AMT. There have been several recent and important developments that your CPA is aware of, including the interaction of AMT and incentive stock options, the AMT and the home

Keeping a Step Ahead of the AMT
continued from page 4—mortgage interest deduction, the AMT and depreciation, and other key areas.

Remember that the AMT is a tax computation independent from regular income tax calculations and, generally speaking, it tends to reduce the tax benefits of many deductions and credits on your tax return.

For example, medical deductions are only allowed for computing the AMT if they exceed 10% of your income. This is a tougher rule than figuring regular income tax, which allows for a medical deduction if medical expenses exceed 7.5% of your income. Our office can talk to you about deferring or accelerating medical expenses, or using a flexible savings account at work to avoid the AMT.

Another interesting feature of the AMT is that it does not take personal exemptions into account (meaning, you do not get to take personal exemptions for your dependents for purposes of calculating the AMT). At the very least, this fact affects the income tax planning considerations of divorced or separated parents, and we will help steer you in the right direction to determine which parent would be better to claim exemption(s) for dependent child(ren).

Individuals should take full notice of the fact that miscellaneous itemized deductions are not deductible for AMT purposes, as well. This means that everything from investment expenses,

employee business expenses, work clothes and uniforms, employee home office expenses, to a myriad of other important deductions are irrelevant for AMT calculations. This fact alone can

have a substantial impact on your AMT liability, causing you to lose deductions you previously relied on heavily to reduce your overall income tax burden.

Again, talk to our office about various solutions to this particular problem, including

deferring business expenses.



AMT exemption and two-tiered rates

Married taxpayers filing jointly have an AMT exemption of \$58,000 (\$29,000 for married persons filing separately and \$40,250 for a single or head of household return) in 2005, but an AMT exemption of only \$45,000 for married taxpayers is currently set for tax years 2006 and beyond (the numbers will be \$33,750 for single taxpayers and heads of household and \$22,500 for married taxpayers filing separately). These exemptions are phased out if your AMT income exceeds certain limits. The AMT rate is 26% on all alternative minimum taxable income in excess of the applicable AMT exemption. That rate rises to 28% when a married couples' AMT income reaches \$175,000 (and \$87,500 for married persons who file separately) in excess of the exemption.

So, while the rates for regular taxation fall into six tiers, there are only two tiers of AMT rates.

This is why it may be critical to have our office handle your taxes. We will fill out Form 6251 to determine whether you owe any AMT. Should you try to do it yourself and err, the IRS will respond to underpayment of taxes with a bill for the amount lacking plus interest and penalties.

At a glance

The following items are *includible* for AMT purposes (meaning, they are subject to the alternative minimum tax). You will need to re-think the way you think for regular income tax purposes: The very things you think of as helpful for computing regular federal income tax liability prove to be much less so for AMT purposes. This list is provided for illustrative purposes, and is not meant to be complete:

- The standard deduction
- State taxes
- Personal exemptions
- Income from the exercise of incentive stock options
- Investment expenses
- Home mortgage interest (only home acquisition debt is deductible)
- Net operating loss deductions
- Deductions for medical expenses
- Tax-exempt interest from private activity bonds
- Small business stock gains (that qualify for a 50% tax exclusion)
- Miscellaneous itemized deductions
- Passive income or loss deductions

Retain Your Key Employees With "Phantom" Stock

If you're a small business owner, you probably count your key employees as some of your most valuable business assets. For you, there would be no worse "trick" at Halloween than to lose one or any of these key players.

Just in time for Halloween, when our neighborhoods are overrun by little ghosts and goblins in sneakers searching for "tricks or treats," we can suggest an incentive that sounds creepy but turns out to be one of the best ways to hold on to

key employees. Contrary to the impression you might get from the name, phantom stock does provide a real and legitimate benefit.

What is phantom stock?

Essentially, phantom stock — also referred to as "shadow stock" or a "unit stock plan" — grants the right to profit from appreciation of your company's profits or sales, rather than from any actual stock in your company. It is a promise to your designated key employees to pay a bonus equivalent to the

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Retain Your Key Employees *continued from page 5*—value of company shares or the increase in value of those shares over a defined period of time. For example, you can offer key employees tax-deferred incentives from the date on which the employee either (1) cashes out in conjunction with a sale or merger transaction; or (2) exercises the option prior to its expiration. Like stock options, phantom stock has a fixed exercise date and a stated formula for determining its value.

As the owner of a privately held company, phantom stock can be your trump card. Typically, you don't have the ability to grant stock options; and if you own a family business, chances are good that your stock is held by family members.

Other benefits. By offering phantom stock, you can generally avoid the high implementation costs and restrictive regulatory requirements related to issuing "real" stock, as well as the headaches associated with stock distribution and dilution. Even if you have a traditional benefit plan using stock (such as an employee stock ownership plan [ESOP] or 401k), you can supplement it with a phantom plan. Limited liability companies (LLCs), sole proprietorships, and partnerships cannot offer traditional types of ownership plans because of restrictions placed on ownership. Phantom stock also allows nonprofit organizations to offer an equity-type incentive to key employees.

This gift has strings attached

Phantom stock arrangements typically require employees to remain with your company for a specified number of years or until retirement before the employee can exercise the right to sell his or her phantom stock — thereby creating

an incentive for the employee to stay on with your company.

Rather than giving your key employees actual stock certificates, you give them something that indicates their ownership of the phantom stock, which is tied to the pricing of your company's "real" stock. And because phantom stock is a type of stock-based incentive compensation, your key employees can watch the price movements typically associated with real stock. You can publish data on stock price in whatever time increments you choose, keeping your employees motivated not only to stay on with your company but to help increase profits for their own personal benefit as well.

Phantom stock plans, varied as they are from company to company, typically limit the full amount of units that may be outstanding at any given time, as well as how much phantom stock should be granted to any particular employee. Our office can help you determine the right number of phantom stock units to create for your most valued key employees. You'll want to plan ahead for future hires, paying special attention not to dole out all units of phantom stock to earlier-hired employees and lose the incentives for later-hired key employees.

Taxation

There are some important tax issues related to phantom stock plans to bear in mind. For the most part, these plans are given the same tax treatment as unfunded deferred compensation plans.

The recipient. Like any cash bonus, the phantom stock is taxed as ordinary income once the employee actually receives a benefit payment, which ordinarily occurs upon retirement or separa-

tion from the company. Benefits are typically paid in installments, rather than in one lump sum.

The corporation. You must report any compensation based on a phantom plan on your key employee's Form W-2, and only then can you take a deduction.

The highly complex set of federal rules (the Employee Retirement Income and Security Act of 1974 or "ERISA") comes into play if you extend a phantom stock plan to most or all of your employees. The goal is to structure your plan as an incentive plan for your key employees. Our office can talk to you about the best way to do this, as well as all of the other intricacies involved with providing phantom stock initiatives on an employee-by-employee basis, rather than as a comprehensive plan offering.

Getting it right

Some phantom stock plans of large corporations have been challenged recently, several of which by corporate stockholders asking a court to consider whether phantom stock plans are valid and whether they wrongfully squander corporate assets.

Overall, the cases hold that a plan is valid (1) if the corporation receives "adequate consideration" for the payments it makes to plan participants (for example, a key employee who brings a great deal of value to a company and has stayed on for a long time); and (2) if there is a "reasonable relationship" between the benefits conferred to the employee under the phantom stock plan and the services the employee actually provided.

In accordance with IRS Circular 230, this newsletter is not to be considered a "covered opinion" or other written tax advice and should not be relied upon for an IRS audit, tax dispute, or any other purpose.

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