

CPA

OCTOBER 2005

Client Bulletin

BUSINESS & TAX PLANNING IDEAS for OUR CLIENTS and FRIENDS

Boo! 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, 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 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

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Did You Know?

Small businesses (including small businesses taxed as corporations):

- Provide about 75 percent of the net new jobs
- Represent more than 99 percent of all employers
- Generate more than 50 percent of America's private sector output

Source: U.S. Treasury Department at www.ustreas.gov

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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 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 a 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

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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 actu-

ally receives a benefit payment, which ordinarily occurs upon retirement or separation 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 associated with the Employee Retirement Income and Security Act of 1974 ("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 only. 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.

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 conditioner, energy-saving windows, or an "energy smart" water heater, among many other energy 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 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

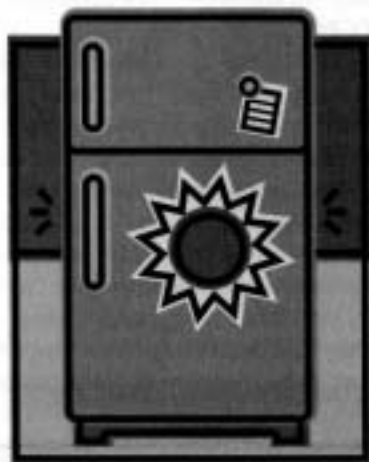
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home and another lesser one for certain energy efficiency improvements made to your existing home.

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 sec-

ond 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 and television time 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 November edition of *CPA Client Bulletin* will feature an article explaining, among other things, how the two new laws work together to supplant and enhance previous legislation on tax breaks for hybrid energy vehicles.

Businesses to Benefit from New Types of IRS-Allowable Signatures

The IRS released new rules that allow corporate officers and their duly authorized agents to use a faxed signature—or an alternative signature method—on certain tax forms. Alternative signature methods include computer software or mechanical devices. These rules will make it easier for business taxpayers to comply with employment tax filings and will reduce the number of returns rejected by the IRS due to signature issues. The rules are effective for forms filed on or after July 1, 2005.

The new rules apply only to the following forms:

- Any form in the 940 series, including Form 940, *Employer's Annual Federal Unemployment Tax Return (FUTA)*; Form 941, *Employer's Quarterly Federal Tax Return*; Form 943, *Employer's Annual Federal Tax Return for Agricultural Employees*;

and Form 945, *Annual Return of Withholding Federal Income Tax*;

- Form 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*;
- Form 8027, *Employer's Annual Information Return of Tip Income and Allocated Tips*;
- Form CT-1, *Employer's Annual Railroad Retirement Tax Return*; and
- Any variant of these forms, such as Form 941c, *Statement to Correct Information* and Form 941-SS, *Employer's Quarterly Federal Tax Return*.

Note: If you file one of these forms, you *must* keep a letter signed by the corporate officer or duly authorized agent that states that he or she adopts the signature and that the facsimile signature was used at the officer or agent's direction. This letter must be kept in your files for four years following the date that the return is due or from the date that the tax is paid, whichever occurs later. Additionally, each letter must identify each return by both name and identifying number.

Help Us Help You — Maintain Accurate, Specific Records

A recent Tax Court case highlights the importance of maintaining good records when claiming deductions on your federal tax returns.

Kelvin and Arlene Jackson v. Commissioner of Internal Revenue addressed, among other things, itemized deductions that the married taxpayers claimed on Schedule A to Form 1040. These deductions included medical and dental expenses, home mortgage interest and points, gifts to charity by cash or check, non-cash gifts to charity, and unreimbursed employee expenses (small tools). The Tax Court determined that the taxpayers owed \$808 in tax, plus penalties.

Of particular interest, the IRS denied the couple a \$350 "small tools" deduction. The court questioned whether the claimed "work" shoes were really "hiking boots"

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used for personal purposes. Another receipt, according to the court's findings, did not even describe the item purchased. Regarding the claimed deductions for charitable contributions, the court found that both names and dollar amounts of alleged gifts were "altered" by the taxpayers, not to mention the fact that the receipts were not contemporaneous in nature (for more on this requirement, refer to the article "Give Win-Win Charitable Contributions Every

Time" in the September 2005 edition of *CPA Client Bulletin*).

Overall, the Tax Court took issue with the fact that, "petitioners presented documents generated by themselves and alleged receipts that were illegible, incomplete, and some of which had been altered." It found that because the taxpayers did not retain required records nor introduce "credible evidence," the burden was on them—the taxpayers—to convince the court of the validity of their claimed

deductions. The taxpayers in this case failed to do so. Thus, the Tax Court found for the IRS and imposed penalties on the taxpayers.

The lesson

Our office itemizes your deductions based on the receipts and other proof you provide us of purchases and donations you make throughout the year, whether for yourself or for your business. Help us help you by maintaining as accurate, complete, and specific records as you can with every purchase and donation you make.

Tax Calendar

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October 11

Employees who work for tips. If you received \$20 or more in tips during September, report them to your employer. You can use Form 4070.

October 17

Individuals. File a 2004 income tax return and pay any tax, interest, and penalties due if you were given an additional 2-month extension.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for September payments if the monthly rule applies.

Partnerships. File a 2004 calendar year return (Form 1065). This due date applies only if you were given an additional 3-month extension. Provide each partner with a copy of Schedule K-1 (Form 1065) or a substitute Schedule K-1.

Electing large partnerships. File a 2004 calendar year return (Form 1065-B). This due date applies only if you were given an additional 3-month extension.

October 31

Employers. File Form 941 for the third quarter of 2005. If you deposited the tax for the quarter in full and on time, you have until November 10 to file the return. For federal unemployment tax, deposit the tax owed through September, if the amount owed exceeds \$500.

NOVEMBER 2005

November 10

Employees who work for tips. If you received \$20 or more in tips during October, report them to your employer. You can use Form 4070.

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the third quarter of 2005. This due date applies only if you deposited the tax for the quarter in full and on time.

November 15

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for October payments if the monthly rule applies.

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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