A taxing year

Tax law for '04 has plenty of 'sleepers.' Prepare now to keep them from becoming nightmares.

BY CHRISTINA P. O'NEILL

The federal government giveth, and the federal government taketh away. While the Bush administration is most known for its propensity for tax cuts, Congress, in a post-Enron era, has been busy this year passing tax laws meant to clamp down on past abuses at the same time it gives out much-welcomed tax breaks for small businesses and manufacturers.

Some of the new provisions are what Bill Philbrick calls "sleepers" — the stealth-mode rules that seem to be hiding in plain sight. We spoke to about a half dozen CPAs and a tax attorney in the Central Mass. finance community to get their input on the tax changes and what they'll mean to you for tax year 2004. Their message — enjoy the breaks, but look out for some tightened provisions that have real teeth.

Continues on page 13

Get the WBJ DAILY REPORT! Sign up today for o

A taxing year

Continued from page 15

The American Jobs Creation Act of 2004, signed into law just this past Oct. 22, is effective for the 2004 tax year. It contains many goodies — a new tax deduction on income earned from manufacturing; a tax break that favors domestic over offshore production; and more generous (and more realistic) depreciation schedules for equipment purchase, particularly software. Additionally, S Corporations are now allowed 100 eligible shareholders, up from 75 — and family members of a business can count as one shareholders' unit.

The rules that have been tightened up — Philbrick's "sleepers" — can be taxpayer nightmares for the unprepared. Congress put teeth into the American Jobs Creation Act of 2004 in two key areas — deferred-compensation plans and so-called "listed transactions" which have far-ranging consequences for the non-compliant.

In addition, says Joy Child of Westboro- and Worceser-based Alexander, Aaronson & Finning & Co., PC, the law imposes other restrictions, including the following:

- Shutting down "abusive" tax shelters
- Tightening rules for charitable contributions of patents, motor vehicles, boats and airplanes
- Limiting the deduction for SUVs to $25,000 a year, down from $100,000 a year ago.

Here, in compact form, and with "carrot" and "stick" symbols, is our checklist of the tax changes most likely to impact businesses for the tax year that's about to end - and what our experts say about them.

Non-qualified deferred-compensation plans

What they are: In these plans, which are not available to rank-and-file employees, key executives can defer bonuses or other compensation into later tax years.

What changed and why: The American Jobs Creation Act of 2004 contains stricter legislation to deal with non-qualified deferred-compensation plans. Congress got tough on these plans as a result of the abuses at Enron Corp. Executives at that company were able to cash out of their deferred-compensation plans just before the firm filed for bankruptcy, getting millions of dollars in non-qualified benefits, observes Robin Lazarow, a tax attorney at Worcester-based Mirick O'Connell. The 2004 law imposes severe penalties for failure to follow Internal Revenue Code Section 409A. Those who fail to do so will owe current income tax on all amounts deferred, plus a 20 percent tax penalty on the amount that's included in income, and interest assessed on the underpayment at the underpayment rate plus 1 percent. Additionally, as of 2005, all amounts deferred must be reported on W-2 forms, even though that money isn't taxable, to provide the IRS a way to track the amount of deferred compensation.

Before 2005, says Lazarow, executives who, say, were still working at their previously agreed upon retirement date were allowed to postpone receipt of deferred-compensation amounts, which they often did in order to receive the distribution in a later year in which they would be in a lower tax bracket. Conversely, they could take early distribution with a penalty, or receive accelerated benefits. Not any more.

Under the new rule, according to a newsletter from Worcester-based Alexander, Aaronson & Finning, executives are going to have to elect ***up front*** when they want to receive their distribution, and only six specific events will trigger a distribution in which the recipient does not have to pay a penalty. Some of these events have yet to be officially defined. In short, they are:

- Separation from service
- Death
- Disability
- A specified distribution time or distribution schedule
- Change in control of the corporation
- Unforeseeable emergency

Meanwhile, executives taking deferred compensation need to make an election in 2004 for their 2005 deferrals. As this issue went to press, lawyers and accountants were waiting for guidance by the U.S. Treasury to help taxpayers through the transition period.

Consequences: Employers must be aware of the consequences of early distribution. "You cannot violate the provisions later on, otherwise you disqualify the plan altogether," warns Philbrick, who warns businesses, "you may end up losing an employee over it."

What to do about it: "Deferred compensation isn't something that many employers have necessarily paid attention to over the years," Lazarow says. "They could have been promising deferred compensation in an employment agreement, for instance, and not realize that, because they don't keep track, necessarily, of all of their promises to pay deferred compensation. So now, employers will really need to take an inventory of those arrangements."

Location, location...

Southbridge 253-257 Main Street (508) 765-9103
Sturbridge 200 Charlton Road (508) 347-2701
Charlton 63 N. Main Street (508) 248-7323
West Warren 2370 Main Street (413) 436-0515
Holden 1073 Main Street (508) 829-0865
Toll Free 800-939-9103
Visit our web site www.southbridgesavingsbank.com

Full Service Supermarket Branches:
Big Y Southbridge 495 E. Main Street (508) 765-1555
Big Y Spencer 70 W. Main Street (508) 885-2221
Big Y Worcester 100 Mayfield Street (508) 792-4950
Shaw's Worcester 115a Gold Star Blvd. (508) 853-6899
Shaw's Webster 82 Worcester Road (508) 949-2600
Big Y Amherst 175 University Drive (413) 259-9500
Big Y West Springfield 503 Memorial Avenue (413) 827-7356

Southbridge Savings Bank
Preserving the past, building for the future. Since 1848.

Accountants
Advisors
For Life.

Alexander Aronson Finning
(508) 366-9100
www.aafcpa.com