

# Tax Talk

*A quarterly publication of Bridges & Dunn-Rankin, LLP*

## Welcome to the first issue of our quarterly newsletter

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Dear clients and friends,

Throughout most of our existence as a firm, one of the items on our to-do list has been to start a quarterly newsletter. Well, after 12+ years, we have finally gotten around to it. Why such procrastination? I guess partly it's because it seems that we have always been running at capacity; just trying to respond to the needs of our clients (which has always been and always will be our top priority), or following up with prospects who have been referred to us. Also, because we provide custom solutions (and not generic ones), we have always preferred to invest our time in customized advice rather than a broad-based newsletter. That won't change.

Nevertheless, we have finally launched our newsletter, which hopefully you will be receiving each quarter going forward. In it, we will cover tax legislation of general interest, tax, accounting and financial topics of general interest to our clients, and potential

planning ideas that might be of interest to you. In order that you can get to know the members of our firm better, we will share with you member news and profile one member of our firm in each issue. We will also share client news and profile one of our clients in each issue. And, we might even play a little Trivial Pursuit.

We hope that you will enjoy our newsletter, and maybe from it you will gain some useful information.

Sincerely,

*Kent Bridges*



Kent Bridges,  
Managing Partner

## Tax Legislation on the Horizon

Any time Congress is in session, tax legislation is likely to be on the agenda. Hot button items at the moment include extension of the 15% rate on capital gains and dividends, alternative minimum tax relief, and estate tax reform.

*15% tax rate on capital gains and dividends* – Legislation enacted in 2003 cut the maximum Federal rate on long-term capital gains and qualified dividends to 15%. However, these favorable rate cuts are set to expire at the end of 2008. President Bush and the Republican-led House favor making these tax cuts permanent, but they will have to garner more support in the Senate.

*Alternative minimum tax relief* – It's estimated that 4 million American taxpayers will pay the AMT for 2005 and that 20 million may incur the AMT for 2006 absent some change in the rules. The AMT was enacted in 1969 to prevent high-income individuals from avoiding paying any income tax through the use of perceived loopholes. Initially, it only applied to a small

number of individuals. Most of our clients are familiar with the AMT (it factors into the planning that we do for all of our clients), but the average taxpayer only learns about it when they get a bill in the mail from the IRS for it. Legislation enacted in 2003 temporarily increased the AMT exemption amounts, but that increase expired in 2005; thus the potential for the AMT to ensnare millions of more taxpayers in 2006. It is unlikely that Congress will want 20 million more angry taxpayers, so, at a minimum, we will likely see the higher exemption amounts extended for at least one more year. There is really no philosophical justification for the AMT, and its complete repeal is always a possibility. However, the revenue cost of complete repeal seems to make such unlikely this year. (See separate article about the AMT).

*Estate tax reform* – The estate tax and its companion, the gift tax, apply to the privilege of transferring wealth, either

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Brock W. Bullard, CPA

## Member in the Spotlight—Brock Bullard

Brock Bullard joined Bridges & Dunn-Rankin in early 2000 after a 2-year stint with Ernst & Young in Charlotte, NC. Brock, a native of Valdosta, Georgia, received both his BBA in Accounting and his Masters with Emphasis in Taxation from The University of Georgia. He was awarded the Silver Medal by the North Carolina Association of Certified Public Accountants for scoring the second highest on the May 1999 CPA Examination.

Brock's wife, Heather, is now a part-time

cardiothoracic surgical nurse and full-time mom to boys Braxton (age 3) and Harrison (age 1). In his younger years, Brock was a world-class dirt-bike rider, traveling the country with his family to compete in motocross events. Fortunately for us, he no longer rides his motorcycle, and now spends most of his outside time with Braxton and Harrison.

Bridges & Dunn-Rankin is proud to have Brock Bullard as a member of our firm.

## The Dreaded AMT

As mentioned earlier in this newsletter, one of the hot-button issues today is the alternative minimum tax ("AMT"). The alternative minimum tax is a separate but parallel system to the regular income tax. You must compute your tax under both systems, and pay the greater of the two. If the AMT is higher than the regular tax then this excess shows up on your return as an additional tax.

The AMT applies for both corporations and individuals. However, for S-corps (and also partnerships and LLCs) the adjustments flow through to the owners for computation on their personal returns, and small C-corps (generally those with average annual revenue of less than \$7.5 million) are exempt from the AMT. Larger C-corps generally incur the AMT only if they are capital-asset intensive and thus have big depreciation adjustments. Further, the AMT rate is lower for C-corps (only 20%). Accordingly, the AMT is mostly an issue for individuals.

For individuals, the AMT is computed largely like the regular tax, except that you don't get certain deductions (e.g. real estate taxes, state income tax, interest on home equity line of credit proceeds used for something other than home

improvements, and miscellaneous itemized deductions) and you have to adjust for accelerated depreciation taken and for the gain on any ISOs exercised and held. Whereas for the regular tax you have a progressive rate bracket system (with Federal rates up to 35%), the AMT is pretty much a flat 28% (except that for dividends and long-term capital gains it is 15% like the regular tax; and a 26% flat rate applies to lower income amounts). Any AMT that you pay as a result of "timing differences" (e.g. depreciation differences or ISO adjustments) becomes a credit carryforward that you can use in any future year in which your regular tax exceeds your AMT, but only to the extent of such excess.

Anyone can potentially be subject to the AMT, but there are certain criteria that make you a more likely candidate:

- *Incentive stock options* – If you exercise and hold ISOs with a significant in-the-money value, you will almost certainly be in the AMT. Fortunately, AMT incurred as a result of ISO exercise becomes a credit that you may be able to use in future years. An article in an upcoming issue of this newsletter will discuss strategies with respect to ISOs.

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## Got a nonqualified deferred comp plan or issuing stock options? Watch out for IRC 409A.

IRC section 409A was enacted in 2004 to curb perceived abuses in the area of executive nonqualified deferred compensation (NQDC). The supposed primary target of this legislation was the situation in which corporate executives enjoyed the benefit of tax deferral on deferred compensation, but then wanted to be able to shelter the deferred compensation from the reach of creditors of the employer corporation in the event the employer's financial health deteriorated (e.g. Enron and Delta). However, the rules as written are quite broad and can cover many more situations; and the ramifications of compensation being subject to 409A are severe.

Section 409A provides that where an NQDC plan fails to meet certain requirements amounts deferred thereunder will be included in taxable income and, in addition to the normal income tax that would apply, will be subjected to an

additional 20% tax plus interest accruing from the year that the amounts were deferred.

Stock options are excluded from the reach of 409A, provided that the exercise price can never be less than the fair market value of the underlying stock as of the date of grant. Accordingly, it is very important to document that the strike price is at least as great as the value of the stock at the date of grant. The proposed regulations acknowledge the difficulty in valuing the stock of a privately-held company; particularly illiquid stock of a start-up company. Under the proposed regulations, a valuation of illiquid stock of a start-up company will be presumed to be reasonable if the valuation is made reasonably and in good faith and evidenced by a written report that takes into account the relevant factors prescribed for valuations in the regulations.

## Tax Legislation on the Horizon

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through gifts during lifetime or at death. There is an annual exclusion which permits you to give up to \$12,000 per year per donee, exclusions for amounts paid for health care, education, and parental support obligations, exclusions for charitable gifts and transfers between spouses, and life-time exemptions which permit each person to transfer up to \$1 million during their lifetime or \$2 million combined during life or at death. With these exclusions and exemptions, only a small percentage of Americans actually incur any estate or gift tax. However, for those who do want to leave a sizeable

## New Deduction for QPAI

Many of our clients will be seeing on their 2005 income tax returns a new deduction for “qualified production activities income” (QPAI). This new deduction, included as part of the 2004 tax legislation, was designed to replace the exclusion for “extraterritorial income” which was repealed after being found by the World Trade Organization to be an illegal subsidy to U.S. exporters. The new QPAI deduction, however, is much broader and applies to net income from U.S. manufacturing, production, growth, extraction, film production, construction,

## Client in the Spotlight—Walton Communities

Walton Communities and its affiliates own and manage over 2,000 apartments in Metro Atlanta. Its principals and affiliates are also active investors in commercial and single-family residential properties.

Walton traces its roots to the early 1970s when founder Barry Teague was developing apartment projects for Post Properties. Barry left Post in 1987 and, after a brief period of retirement, joined with sister Lynda Ausburn in 1988 to form Teague-Ausburn Properties, Inc. and focus on developing family-oriented apartment communities.

In 1999, Teague-Ausburn merged with Knight Davidson Companies to form Walton Communities. Knight Davidson had been a leading home builder and apartment developer in Cobb County since 1988. The Knight Davidson Companies, and their principals David Knight and Keith Davidson, were amongst the earliest clients of Bridges & Dunn-Rankin, and it

inheritance to their heirs, the estate tax can consume almost 50% of their wealth. Opponents of the estate tax have labeled it the “death tax”, and have been quite effective at lobbying for repeal of this unpopular tax. The House has passed legislation to repeal the estate tax, but the repeal legislation is a few votes short in the Senate. At this point, repeal appears unlikely, but it is quite possible that we will see the exemption amounts permanently increased (perhaps in the \$5 million to \$10 million range) and the rate permanently reduced (to say 25%).

software development, and architectural and engineering services.

The deduction, subject to some limitations, will, in general be 3% of the net income from such activities for 2005 and 2006, 6% for 2007 – 2009, and 9% for 2010 and beyond. These deduction amounts roughly equate to a reduction in the otherwise applicable tax rate of 1%, 2%, and 3%, respectively. The deduction is available for all types of business entities (C-corps, S-corps, partnerships, LLCs, sole proprietorships, etc.).

was this relationship that led to our involvement with Barry, Lynda and Walton Communities. We were quite delighted to be chosen as the CPA firm for the merged company and its principals and affiliates.

Walton Communities’ corporate purpose, as stated on a plaque at the front door of their offices, is “To glorify God by being a positive influence on everyone we encounter, and by being a good steward of all that has been entrusted to us.” In our experience with Walton, they certainly live up to that. Bridges & Dunn-Rankin is proud to be associated with Walton Communities.



Walton Communities Support Office

## New Service Offering—SEC Technical Services

Sander Abernathy, partner in charge of our audit practice, brings to the table deep expertise and experience in SEC reporting. In order to more fully utilize his SEC reporting background, we have launched a new service offering - assisting smaller publicly-traded companies in preparing their 10Q and 10K filings with the SEC, work that in today’s regulatory environment typically cannot be performed by the company’s outside auditor. If you are involved with a publicly-traded company that may need some assistance in this area or would like to know more about our services, please contact Sander.

## Your referrals are appreciated

We are sometimes asked “Are you accepting new clients?” The answer is “yes.” We have been very blessed over the years, and always seem to have plenty to do. However, due to natural attrition (e.g. clients selling their business) and the need to provide growth opportunities for our employees, we must always be on the lookout for new clients. Our new business comes almost exclusively from referrals, and so we greatly appreciate your referrals.

## The Dreaded AMT

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- *Significant capital gain* – If you live in a state with a state income tax and realize a substantial long-term capital gain, you will most likely be in the AMT posture; either in the year of the capital gain or the following year (or both), depending on when you pay your state income tax. The reason is that your marginal tax rate both for regular and AMT purposes will likely be 15%, but you will get no deduction against AMT income for the significant state income tax you pay on the capital gain. Careful planning as to the timing of payment of your state income tax can often minimize the amount of your deduction for such that is effectively lost.
- *Income between \$150,000 and \$500,000* – For those with income below \$150,000, usually the AMT exemption will enable them to avoid it. For those with ordinary income above \$500,000, generally enough of their income is subject to the highest rate bracket (35%) that the AMT (which caps out at 28%) does not come into play. For anyone with ordinary income between these two amounts, however, if you

live in a state with a state income tax you will likely be in or very near the AMT.

- *Investors* – Individuals who derive most of their income from investments generally enjoy a very favorable Federal regular rate on most of their income (e.g. the 15% rate on dividends and long-term capital gains). This, coupled with the addbacks for state income taxes, real estate taxes, and investment expenses, makes investors likely candidates for the AMT almost regardless of income level.
- *Capital intensive businesses* – If you enjoy the benefits of accelerated depreciation on fixed assets, you may find much of that benefit taken back by the slower depreciation methods and periods required under the AMT.

The upside of incurring AMT is that it means your marginal Federal rate is at most 28% (versus potentially 35%). However, it does mean that you are losing the benefit of some of your deductions. The key is to plan properly in order to minimize the negative impact of the AMT.

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Bridges & Dunn-Rankin, LLP is an Atlanta-based full-service accounting firm serving clients in the technology, real estate, services, manufacturing, distribution, construction and healthcare industries, as well as high net worth individuals.

*The information provided in this newsletter is presented for educational and informational purposes only, and is not intended to constitute legal, tax or accounting advice. The articles provide only a very general summary of complex rules. For advice on how these rules may apply to your specific situation, contact a professional tax advisor.*

### Trivial Pursuit

The alternative minimum tax (AMT) was enacted in 1969 after Congress heard testimony that some individuals with 1967 income in excess of \$200,000 had paid zero Federal income tax. This quarter's trivia question is "What was the number of taxpayers with 1967 income in excess of \$200,000 who reportedly had paid zero income tax and were thus presumably the targets of the AMT?"

The first person to provide the correct number (or the number closest thereto if no one is correct) will receive 4 tickets to a Braves game of their choice. E-mail your answer to [laura.niklasson@bridgesdunnrankin.com](mailto:laura.niklasson@bridgesdunnrankin.com) on or before March 31, 2006.