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BIG IDEA BOOK

Smart Ideas from Greater Washington's Brightest Minds

Washington smartCEO

Required Reading for Growing Companies

SANTOS, POSTAL & COMPANY, PC

Taxes: Fact or Fiction?

Business associates…friends…relatives…everyone is trying to understand tax laws. Here are some widely-believed misconceptions about taxes. Be sure to understand what's real and what's not.

MYTH#1: You have to pay income tax on money you inherit. It depends on what you inherit. Bequests are generally not taxable. However, if you are the beneficiary of the deceased's pension plan or traditional IRA, you will have to pay tax on the distributions. Additionally, the beneficiary will have to pay income tax on any income that the estate earns on its investments.

MYTH#2: Assets in a living trust are not subject to estate tax. In a properly structured living trust, the assets may avoid probate, but they will be included in your taxable estate. Any assets not in the trust will be subject to probate.

MYTH#3: Married couples should title their assets jointly in order to avoid costly estate tax. If your estate gets too large, holding your assets jointly could cost more.

MYTH#4: Recipients pay tax on the gifts they receive. Actually the donor not the recipient is subject to potential gift tax when making gifts. A donor is given an annual gift tax exclusion of $11,000 per recipient per year. Gifts over that amount are subject to gift taxes at rates of up to 50 percent. Fortunately, there is a lifetime exclusion of $1,000,000 per individual before they are subject to gift tax. This exclusion is part of a lifetime federal estate tax exclusion of $1,500,000. While the federal estate tax exclusion will increase to $3.5 million in 2009, the gift tax exclusion will stay at $1,000,000. Beware—the $11,000 annual exclusion includes wedding gifts, birthday gifts and money you slip to your nephew.

MYTH#5: If you receive a notice correcting an item on your tax return, your return can no longer be audited. The notices you receive are usually a result of a computerized matching program that the IRS uses to check compliance with W-2 and 1099 filings. The IRS also uses a separate program with which returns are randomly or semi-randomly selected for audit. It is only after the IRS completes one of these audits (or the statute of limitation expires) that your return becomes audit free.

MYTH#6: Notices you receive on your tax returns are never wrong. The IRS often has trouble keeping up with the nuances of the tax system, and may send out notices that are incorrect. You should never pay a tax notice until you first check with your tax preparer. That being said, you should never, ever ignore a tax notice. The IRS computer never forgets, and future notices will become more difficult to correct.

MYTH#7: Interest on Treasury Bills is not subject to tax. While interest earned on treasury bills is usually exempt from state income tax, it is still subject to federal income tax.

MYTH#8: Municipal bonds are not subject to state income taxes. Generally, interest income on municipal bonds is not subject to federal income tax. Additionally, you are usually exempt from state income tax on interest income from obligations of your state. However, except for residents of DC, interest received on obligations of other states is usually subject to state income tax.

MYTH#9: Only rich people are subject to alternative minimum tax. The alternative minimum tax (AMT) is a complex set of rules and regulations approved by Congress to make sure that the very wealthy didn't entirely escape paying income tax. Congress set a static, deductible threshold to prevent AMT from applying to taxpayers in lower tax brackets. However, as inflation has increased, income thresholds have remained the same so that each year more people become subject to AMT.

MYTH#10: The maximum tax on capital gains is 15 percent. Politicians bragged about the reduction of the capital gains rate from 20 percent to 15 percent. However, the AMT may add another five percent onto your capital gains rate. This is especially true if your capital gains are disproportionate to your other income.

MYTH#11: Furniture and supplies bought over the Internet are not subject to sales tax. Both individuals and business are subject to a use tax if they are not charged sales tax at the point of sale. States have been getting tougher on this rule, and many businesses will start to see sales tax audits from the states in which they operate. Once audited, the state will assess large penalties for failing to file use tax returns, often looking back at five years worth of information.

MYTH#12: Owners of vacation homes can get a tax deduction for donating the use of their vacation home to charities. Tax law prohibits a donation of rental time (called a donation of a "partial interest").

MYTH#13: Limited Liability Companies (LLCs) are taxed like corporations. Unless the members elect to be treated otherwise, LLCs with multiple members are treated like partnerships. Single member LLCs are not required to file a separate return. Instead, the results of their operations are included on the individual's personal 1040.

MYTH#14: Members of an LLC can receive a W-2. Unless the members elect to be treated as a corporation, the members cannot be treated as employees. Consequently, they cannot have withholdings and they cannot receive a W-2. Members of LLCs will have to make quarterly estimated payments to satisfy their federal and state tax obligations.

MYTH#15: Any business can buy an SUV and get a huge tax deduction. In order to get a tax deduction for the use of a vehicle, there must be a business purpose for its use. In order to receive large tax deductions, the business use has to be greater than 50 percent. In all cases, the owner is required to keep contemporaneous records of the business use.

Be sure to consult with your tax advisor and financial planner to ensure that your personal issues are addressed in order to comply with the law while minimizing your tax exposure. Once you understand what you owe (and don't owe), paying taxes becomes a lot less worrisome.

Santos, Postal & Company, P.C. assists local and regional businesses with their financial, tax and business planning needs. Charles is a member of the AICPA, the Maryland Association of CPAs, the Greater Washington Society of CPAs, and the Institute of Business Appraisers. The Accounting Research Association has recognized Charles for his support of independent research and standard setting accounting principles. Charles was named in 2004 and 2005 one of Maryland's Top CPA's by *SmartCEO* magazine. To contact Charles, call 240-499-2040 or email him at cpostal@spccpas.com.

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