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Separating Tax Myths From Reality

While there is a long list of tax myths, these three common myths just won't die!

Myth #1: Form a corporation and save a ton of income taxes by deducting personal expenses as business expenses.

Contrary to popular belief, forming a corporation does not magically transform personal expenses into business expenses. If you have a legitimate business, then legitimate business expenses are deductible. You do not have to form an expensive corporation to get those deductions. You do have to form a legitimate business organized for the purpose of making a profit. To be deductible, the expenses must be ordinary and necessary for the type of business.

A regular C corporation can be quite expensive to maintain. Corporate books and records must be kept, minimum state taxes must be paid, and an annual tax return must be prepared and filed, even if there is a loss.

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If the corporation has income, it will owe taxes. To pull out those taxed profits, there may be a separate personal tax. A corporation's assets, which increase in value, cannot be withdrawn from the corporation without paying tax on the appreciation. This applies even if you are the sole owner and you are giving the asset to yourself.

It is expensive to kill a corporation, and you are personally liable for any unpaid corporate income taxes. Even if there is a tax audit years later, you are on the hook with no deduction.

If you use a portion of your home exclusively for your business, you may be able to deduct that use. You must allocate between the business and personal uses of your equipment and other items. Accordingly, many expenses you previously treated solely as personal expenses become business expenses.

This transformation does not come with incorporation; it occurs because you start a business. You do not necessarily need to form an expensive and high maintenance corporation to run a business. Other options include sole proprietorship (using Schedule C on your Form 1040), or a single member LLC for the protection of limited liability without the hassle of filing business tax returns. Get expert advice before determining your business's form of entity.

Myth #2: Lease, rather than purchase, a car and get a business tax deduction.

The benefits of leasing are that you typically don't need a large down-payment, and you are able to use a new car and not have to fully amortize an auto loan. The lessor estimates what the car's resale value will be at the end of the lease; that is your lease termination purchase price. If the car on a three-year lease is worth $60,000 brand new, for example, and is estimated to be worth $40,000 at the end of three years, then you essentially are getting a loan of $60,000, which after three years of payments will still have a balance of $40,000. Your options are to turn the car back in and let the lessor pay off the loan, or pay the $40,000 residual and keep the car. If the interest rate is low on the underlying loan, then the economics might make sense.

There are two more things to consider, however. One is that you usually will incur more sales/use tax on a lease (typically charged on every payment, and on the final payment if you purchase) than if you purchased the car outright.

The second consideration is that the often-hidden lease interest rate may appear to be amazingly low. You wonder how you could ever get a better deal! Be careful, though: you may be charged 10 cents or 15 cents a mile over 8,000 or 10,000 miles a year. The lessor's position is that a high mileage car may not be worth $40,000 at the end of the lease. But take a hard look at how many miles you really drive each year, as the mileage surcharge may end up offsetting your ultra-low interest rate.

To the extent a leased car is used in a business and proper travel logs are kept, the lease expense as well as hard operating expenses will be deductible. Alternatively, the IRS will permit you to take a per-mile allowance.

If you buy (not lease) the car and use it for business, you need to keep a travel log just as you do for a leased car. You are allowed a deduction for the business use portion of the car, depreciation, and possibly bonus depreciation. The interest on the loan is tax deductible, so you may end up earning more deductions sooner with the purchase/finance option. The purchase and depreciate option almost always generates greater tax deductions and usually ends up being less expensive.

The drawback on the purchase is the financing. You usually need more cash up front to buy, although it is probably well worth it to make this investment. Many auto dealers also offer very favorable interest rates on loans.

Myth #3: An IRS audit is more daunting and painful than a root canal.

Many individuals and business owners dread the thought of an IRS audit. Receipt of an audit notice invokes fear they will be raked over the coals, lose their savings, or even lose their business. In most cases these are needless worries.

Audits can be nearly painless if you remember and apply these simple principles. First, you don't need to deal with the IRS agent at all if you will give a power of attorney to an Enrolled Agent, CPA or lawyer. If you do choose to meet with the agent yourself, then realize that he or she has no personal grudge against you. There was something on your tax return that triggered the audit and they are meeting with you to get the answers. Believe it or not, auditors get just as much credit for doing a good job, whether they give you a refund or they end up collecting more taxes. Auditors are not collection agents. If an IRS collection agent is after you, there is a whole different set of principles that apply.

Time is your friend when it comes to an audit. Do not rush the process. You may be better off granting an extension to the statute of limitations to give the auditor a chance to finish his job. Space out your meetings to give yourself the time you need to gather the information that was requested. If you do not have all the requested information, bring what you have to the meeting and then schedule a follow-up meeting to provide the balance.

Before you start digging out all your records, cancelled checks, travel logs, etc., meet with the agent and find out what triggered the audit and what specific answers he or she is seeking. Then gather the information needed to address those specific issues.

Auditors are human beings with differing levels of experience, ability and personality. Many feel they are disliked and worry that you will be abusive to them - so your polite cooperation will be appreciated. Also, your reassurance that you are an honest person who wants to be treated fairly, as well as wanting to treat the agent fairly, goes a long way.

At the end of the audit the auditor will write up a report that shows his or her suggested changes. You will have the opportunity to either agree or disagree. If you disagree you have the opportunity to meet with an appeals officer before you have to pay any taxes. Don't waste your time arguing with the auditor. Let him or her write up the report, and then move on to the appeal. The appeals process is very successful, as the officers are very experienced, technically competent, and conciliatory. They know when the auditor is wrong or unreasonable, and want to settle with you so you do not take your case on to Tax Court. The appeals officer gets his or her rewards for reaching an agreed settlement with you.

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