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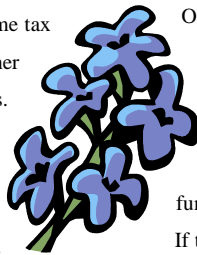
Client Update

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States Can Tax Interest on Out-of-State Municipal Bonds

Thirty-seven states, including Kentucky, impose state income tax on the interest earned on municipal bonds issued by another state while exempting the interest on their own state’s bonds. One couple in Kentucky challenged this tax policy, arguing that this treatment of interest was discriminatory and violated the U.S. Constitution’s so-called “dormant commerce clause.” The dormant commerce clause prevents a state from using “measures designed to benefit in-state economic interest by burdening out-of-state competitors” and arguably prohibits a state from taxing a transaction more heavily when it crosses state lines. The Kentucky Court of Appeals invalidated Kentucky’s policy on the grounds that it violated the dormant commerce clause, but the U.S. Supreme Court reversed. The Supreme Court endorsed a state’s right to tax interest on out-of-state bonds while exempting interest on its own bonds. The Court, in overturning the decision of the Kentucky Court of Appeals, said that when there are compelling reasons for discriminatory tax treatment, such treatment can withstand the commerce clause challenge. In this case, taxing the interest on out-of-state bonds merely favors a traditional government function (taxation). This tax arrangement is critical to the operation of the municipal finance market, as it preserves the tax incentives for investors in municipal bonds and in single-state bond funds (there are more than 500 funds with assets over \$155 billion). Many feared that if the Supreme Court agreed with the Kentucky court decision, the ability of states to raise money through the sale of their bonds would be severely impaired. In general, interest in municipal bonds is not subject to federal income tax. However, interest on bonds used for private activities, such as building a sports stadium is free from regular tax but subject to the alternative minimum tax.



J.K. Lasser’s Monthly Tax Letter, April 2008

Social Security Benefits for Children

Older men who are widowed or divorced often start second families. And when these do-over dads start collecting Social Security benefits, minor children at home can benefit, too. More than 500,000 children currently receive monthly payments based on a parent’s Social Security retirement benefits. The benefits could build a great college fund if they are deposited in a state-sponsored 529 college savings plan. If the child receives \$500 a month, for example, and the account earns an average 5% annual return, the college fund will be worth about \$75,000 in 10 years. Distributions would be tax free if used to pay for tuition, books, fees and other qualified expenses.

Kiplinger’s Personal Finance Adviser, July 2008

Know the Ins and Outs of ‘Reasonable Compensation’

The IRS may object to the compensation of shareholder-employees of a corporation. If the compensation is deemed too high or too low – in other words it is not reasonable under the circumstances – the IRS could force you to make adjustments that increase taxes. This can be particularly troublesome for: S corporation owners who arrange to receive little compensation or no compensation at all, to reduce payroll taxes. C corporation owners and executives who are also shareholders and receive salaries the IRS considers too large because they will then be hit with double taxation. Why? Compensation is fully deductible if it’s considered reasonable. But if a salary is deemed too large, Uncle Sam can label part of the payments as “disguised dividends,” which are taxed twice. Double taxation comes into play because when the corporation distributes profits as salaries, the firm gets a deduction for the amount. The owner or executive pays personal income tax on the money, of course, but it’s only taxed once. But if the corporation pays the owner or executive a dividend, the money is taxed twice – once at the corporate level and again at the personal level.

Not surprisingly, the issue of reasonable compensation is frequently contested in the courts. Here are two examples:

Taxpayer Loser – The shareholder employee of a family-owned corporation served as its president. The three other officers of the corporation were the president’s sons. According to court documents, she voted on major corporate decisions for the waste pickup and disposal business and performed other duties, such as attending civic functions as a company representative. Nevertheless, the IRS argued that she functioned more like an outside board chairperson, rather than a chief executive, and was unreasonably overcompensated. The Tax Court determined that her salary for the three years in question should be \$98,000, \$101,000 and \$106,000 rather than the amounts deducted by the corporation (\$860,680, \$818,060 and \$600,060 respectively). The company appealed the decision. The 9th Circuit Court focused on the following factors to determine a reasonable amount of compensation for the owner-employee:

- The employee’s role in the company.
- A comparison of the compensation paid to the employee with the amounts typically paid to employees of other companies in similar situations.
- The characters and conditions of the company whether a conflict of interest exists that might allow the company to disguise dividends as deductible compensation.
- Whether compensation was paid under a structured, formal and consistent plan.

Based on these five factors, the appeals court concluded compensation should be adjusted to reflect her performance as president of the company.

Taxpayer Winner – by documenting the reasons for corporate salaries, you may be able to fend off the IRS. In one Tax Court case, for example a business gained some leeway because it paid a windfall amount to make up for salary shortfalls in the past. In the case, a father and son were owners and principal employees of a mechanical contracting business. For the year in question, the father was paid a salary of \$260,000, plus standard fringe benefits. The IRS said that \$65,000 of this salary represented unreasonable compensation. But by looking at several factors, including the fact that the father had been underpaid in prior years in order to build up the company cash reserve, the Tax Court determined that the entire compensation amount was reasonable.

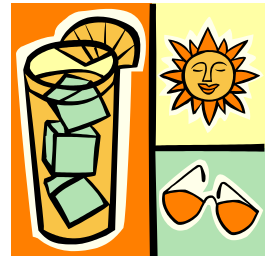
Salary vs. Dividends: Yesterday, Today – and Tomorrow: in the past, C corporation owners often arranged to be paid relatively high compensation amounts in order to increase business deductions instead of paying out nondeductible dividends. That’s because dividends used to be taxed at regular income tax rates. However, qualified dividends are

currently taxed at the same favorable federal rates as long-term capital gains. As a result, high salaries are not necessarily preferred today. But there is a sunset provision in the tax law. Unless Congress takes further action, dividends received after 2008 will once again be taxed at regular income tax rates, instead of the favorable capital gains rates. So shareholder employees may someday again prefer salary payments over dividends.

http://www.cpa-resource.com/articles/view.php?article_id=838&page_number=1

Avoid Sneaky Travel Fees

Summertime is travel time. With prices skyrocketing, travelers need to be vigilant to avoid unnecessary fees imposed by hotels and airlines. Upscale hotels, for example, may impose an extra “resort fee” for amenities such as pools, spas or golf courses. Ask the hotel about such a fee when you book. If you don’t use these services, say so. Generally, the



hotel will remove it because it wants you to come back. Sneaky fees can also start piling up before your trip. Many online travel agencies, including Orbitz.com and CheapOair.com, charge \$5 to \$35 for booking airfares. Avoid that charge by going directly to the airline’s Website, or go to Kayak.com, Farecast.com or AirfareWatchdog.com to find the cheapest fare; they’ll redirect you to the airline when it’s time to buy. Airlines are also increasing fees for overweight bags. Delta, for example,

recently upped its fee for overweight bags and now charges \$80 for a suitcase that weighs 51 to 70 pounds. Avoid paying up by reviewing each airlines baggage policies. OneBag.com offers tips on packing light.

Kiplinger’s Personal Finance Adviser, July 2008

When to Accept a Job Buyout

If you’re close to retiring and your employer offers you a buyout package first decide whether you want to retire. The severance package may seem like a windfall, but it has to push you across the retirement finish line. If you have to choose between a lump sum and a steady stream of pension payments, figure out how much your monthly payment would be if you used the lump sum to buy an annuity from an insurance company. Compare prices at www.annuityshopper.com. If the monthly pension payment is more than the estimated annuity check, take the pension payments. Some buyout offers sweeten the deal with health care incentives-for example, paying health insurance premiums for the first few months after the buyout- but many early retirees with preexisting medical conditions struggle to find affordable insurance. Use an insurance broker to help you find the best deal.

Kiplinger’s Personal Finance Adviser, June 2008

