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Minimizing Taxes Through Effective Planning

Phillip L. Jelsma

Partner - Luce Forward
619.699.2565
pjelsma@luce.com
www.luce.com/phillipjelsma

Editor's Note: Phil Jelsma is an attorney at Luce, Forward, Hamilton & Scripps LLP, a prominent California law firm, and a member of its action sports group which is committed to providing comprehensive legal services to action sports businesses worldwide and includes multiple specialties such as business, intellectual property, financing, tax and estate planning, labor and employment, product liability, general litigation and real estate.

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Many action sports companies and other start-ups fail to take full advantage of some of the tax benefits available for small businesses. If you are a small business owner, the following tax planning ideas may result in significant tax savings. Always consult your CPA or tax advisor to determine whether these suggestions are appropriate.

S Corporations: For an action sports company or start-up that is formed as a C corporation, electing S corporation status can often reduce your income taxes by eliminating the corporate tax on business income. Further, many S corporation shareholders can effectively plan for self-employment taxes. An S corporation is a pass-through entity such that the income or loss of the business goes on to the shareholders' returns. Thus, if the business operates at a loss, a loss can be transferred to the shareholder, and if the business operates profitably, only the shareholder, and not the corporation, pays taxes on the income. One advantage that the C corporation offers over an S corporation is that if the shareholder holds the stock for five years and sells it at a gain, it is possible to recognize a 50 percent capital gains exclusion. The Obama Administration has proposed increasing this to a 100 percent exclusion. Unfortunately, the exclusion is limited to ten times the shareholder's basis in its stock. California does impose a 1½ percent franchise tax on S corporation income.

Bad Debt Expense: In a bad economy, many businesses fail to focus on their accounts receivable to determine which ones are either fully or partially collectible. To the extent the bad debts are worthless, they can be deducted in the year they become worthless. If you use a collection agency, you can deduct the portion of the debt that will go to the agency as a fee (typically around 25 percent). You can write that portion of the debt off in the year that you turn it over to the agency.

Net Operating Losses: For most small businesses, losses earned in 2008 or 2009 can be carried back up to five years and carried forward twenty years. These provisions are available if the business averages less than $15 million of average gross receipts. To get a refund, file an application on Form 1139 for corporations and Form 1045 for individuals or sole proprietorships.

New Equipment Purchases: Most new equipment can either be depreciated or expensed immediately under Section 179. For 2009, the amount that could be expensed immediately was limited to $250,000. For 2010, it is supposed to be reduced to $134,000, but the Obama Administration has proposed extending it for the current year to be eligible for the 179 deduction. The asset must be used at least 50 percent for business in the first year placed in service. In addition, there are limitations on how much equipment is entitled to the Section 179 deduction. For each dollar purchase that exceeded $800,000 in 2009, or $530,000 in 2010, the amount of the Section 179 deduction is reduced by $1. This provision is intended directly to help small businesses.

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Home Office Deductions: Many start-up businesses start out in someone's living room and garage. Generally, home office expenses are deductible, even if you use the space for administrative purposes as long as there is nowhere else you can work. For example, if you use one room out of a six-room home as an office, you may be eligible to deduct one-sixth of the cost for utilities and insurance, as well as a depreciation deduction. However, to the extent that you depreciate the residence, it may affect your $250,000 or $500,000 exclusion on the sale of the house.

While the above mentioned tax benefits do not comprise a definitive list of all the different tax planning opportunities available to small businesses, they are some of the most common benefits that start-ups should consider come tax season.