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A tax, business, and financial planning newsletter for our clients and friends

The Best Tax Shelter Is Still Owning Your Own Business

Owning your own business means that you make all the major decisions, including the ones that can have a real impact on your taxes.

One of the earliest and most important decisions you'll make is to choose the legal form your business should adopt. The most common forms are a sole proprietorship, a partnership, or a corporation. Each has different tax consequences and making the right choice can have a very positive effect on your tax picture.

Sole Proprietorships

A sole proprietor is an unincorporated business that has only one owner. It is a simple legal entity in which you are your own master.

A sole proprietorship has three major tax advantages:

- You can deduct any losses you incur from your business start up costs on your personal income tax return. These start up costs can be used to reduce your taxable income from other sources.
- You avoid double taxation. Income generated from a regular corporation is taxed twice. First, your business pays a corporate income tax on its profits. And then, as a share-



- holder, you pay personal income taxes on any dividends you receive from the corporation. On the other hand, income from a sole proprietorship is taxed only once - as income on your personal income tax return.
- Your overall tax burden may be less depending upon the tax bracket you are in.

Partnerships

A partnership is similar to a sole proprietorship with the exception that it has more than one owner. Each

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taxPOINTS

Loophole: Sell real estate at a gain, but defer paying tax, by executing a Section 1031 exchange.

When you exchange real property for "like-kind" property, taxes are deferred until the second property is sold. Example: You pay no tax when you swap a motel or warehouse for an apartment or office building because this is considered a "like-kind" exchange.

With interest rates still at historic lows, you should make it your business to know what various types of income-producing investments will pay you on a comparable pretax basis. Don't be misled by nominal rates or promises of "tax free" or "tax favored."

How: Compute pretax equivalent rates for different investments and compare. Do this by dividing what each pays by one minus the applicable tax rate.

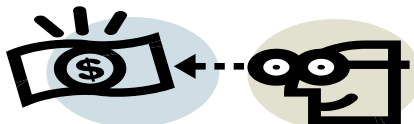
Example: For simplicity, the following illustration considers federal taxes only and ignores state and local income taxes. If you are in the 28% tax bracket, divide the yield from a tax-exempt bond by 0.72 (1 - 28%).

Result: A 4% tax-exempt bond is equivalent to a 5.6% taxable bond. Check all investment options this way.

Unemployment compensation. Many individuals are surprised to learn that unemployment benefits are taxable. The new stimulus package excludes up to \$2,400 of unemployment compensation from recipient's gross income for 2009.

The Seven Commandments for Getting a Business Loan

1 Find a lender that understands your industry. The best sources for this information are trade associations, business associates and your accountant.



2 Never depend on only one lender. While some banks may judge your loan as high risk, others may see it in a positive light.

3 Always borrow more than you need. Most businesses underestimate their capital requirements by 15%. Play it safe and request 25% more than you think you'll need.

4 Borrow before you need the money. Apply for a loan at least

three months before you need the money. This will give you time to shop for the best deal and to negotiate a more favorable loan.

5 Request a loan when your business looks its best. Receipt of a major contract or a sudden improvement in profits will impress a lender and improve your chances for successful borrowing.

6 Borrow enough to build a capital reserve. Invest the funds you don't need immediately in a money market fund for instant liquidity.

7 Be prepared to go to lenders other than banks. When money is tight, banks may turn down a loan request. If a bank says "no", check out alternative sources such as venture capitalists, finance companies, and government agencies.

Maximize Charitable Donations of Stock

To maximize charitable donations of stock, sell shares for a loss, deduct the capital losses on your return, and then give cash to the charity. You get the capital loss write-off plus the charitable deduction - a double tax benefit.

Donate profitable shares directly instead of selling them and donating cash. You can deduct the full current market value of publicly traded shares you've owned for more than one year. Plus, when you give the appreciated stock away, you get rid of the built-in capital gains tax liability. And you might also save any AMT. So this idea could be a triple tax saver.

Estate Planning

Attorney's fees for personal matters, such as drawing up a will, are not deductible. However, if fees relate to tax issues, that portion can be deductible. For example, determining how to minimize the income tax on an IRA distribution and other income tax-favored issues would be deductible.



Hot Tax Breaks for College

The cost of education keeps going up faster than the rate of inflation, but Congress has created tax breaks to help with education expenses.

1. Hope tax credit.

This can be worth up to \$2,500 per student. The amount of the Hope credit is 100% of the first \$2,000 of education costs plus 25% of the next \$2,000.

Limitations:

- The credit is available for the first four years of postsecondary education per student.
- The student must be pursuing a degree or other recognized education credential and be enrolled at least half-time.
- The credit is phased out as your modified adjusted gross income (MAGI) exceeds \$80,000 on a single return, and \$160,000 on a joint return.

2. Lifetime Learning Credit

This can be as much as \$2,000 / tax return.

- The credit equals 20% of the first \$10,000 of education expenses (maximum credit per taxpayer regardless of the number of students).
- The credit may be claimed for a student for any number of years.
- The student need not be pursuing a degree and may be taking only one course.

Credit planning:

The Hope credit and Lifetime Learning credit can't both be claimed for the same student in the same year, but both can be claimed on the same return for different students (such as a child in college and a parent taking a work-related course).



3. Student-loan interest deduction

This is available for up to \$2,500 of loan interest even for those who don't itemize deductions on their tax returns. Loan origination fees are deductible, too.

Snag: Those who don't itemize often overlook this deduction.

The deduction is available for interest on a loan used to finance tuition, fees, room and board, books, equipment, and other necessary expenses (such as transportation) at virtually all accredited postsecondary and vocational schools.

Limit: The deduction is phased out as MAGI increase from \$60,000 to \$75,000 on a single return and from \$120,000 to \$150,000 on a joint return.

4. Coverdell Education Savings Accounts (ESAs)

Can receive up to \$2,000 per year for any single beneficiary under age 18. ESAs earn tax-deferred investment returns which can be used tax free to pay education expenses.

Advantage: ESAs can be used to pay for elementary through high school, not just college.

To contribute to an ESA, one must have MAGI not exceeding \$110,000 on single returns or \$220,000 for married filing jointly. Anyone can contribute to an ESA for an individual, so if parents are unable to, a friend or other relative may contribute.

5. Qualified tuition programs (Section 529 plans)

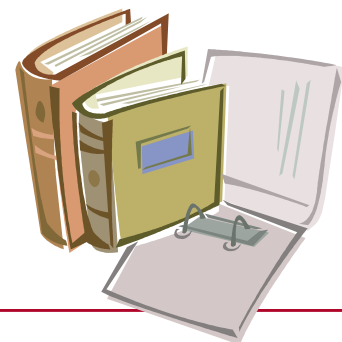
These plans can hold funds that earn tax-deferred investment returns which can be spent tax free on college education costs. Or they can be prepaid tuition plans allowing a person to buy tuition now at today's prices.

Advantage: These plans can hold far more than ESAs and therefore can be used for estate planning. Yet a person who contributes funds to the plan can withdraw them in case of need – a unique instance of being able to “keep while giving away” under the Tax Code.

6. Tax-free scholarships, fellowships, and need-based grants

These forms of aid generally are tax free when funds received are applied to tuition, fees and required course-related expenses (such as books, supplies, and equipment).

Beware: Funds applied to the cost of room and board, travel, or research are taxable.



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The Best Tax Shelter

partner's share of income, loss, and deductions is set forth in the partnership agreement. As in a sole proprietorship, these items are reflected on each partner's personal income tax return.

Partnerships have additional tax advantages:

- Income is taxed at each individual partner's personal income tax rate.
- You avoid double taxation because a partnership does not pay taxes.
- As a partner, you can deduct business losses to the extent that you are liable for obligations of the partnership. You can allocate losses differently than profits. If you provide most of the start up costs, you can take a larger share of the losses, even if the profits are shared equally by the partners. And the way you allocate profit and loss to each partner can be changed from year to year to accommodate changes in your personal circumstances.

"S" Corporations

An "S" corporation is a business that is formed under the rules of Subchapter S of the Tax Code.

Operating your business as an "S" corporation has several tax advantages:

- You may pay less taxes, depending upon the tax bracket you are in.
- You avoid double taxation. Your business profits are taxed only once, directly to you as a shareholder, on your personal income tax return.
- You avoid tax penalties on excess accumulated earnings. Since "S" corporation profits are taxed to stockholders even if they don't receive them, you can't be penalized for accumulated excess earnings in the business as can a regular corporation.
- You don't pay double taxes when your "S" corporation is liquidated. If a regular corporation is liquidated, the corporation is taxed on the gain and you and other shareholders are taxed on the portion of the gain which you receive. Since there are no corporate income taxes for an "S" corporation, you avoid double taxation when an "S" corporation is liquidated.

Regular "C" Corporations

Regular "C" corporations are a unique form of business. They are subject to a special tax structure and their earnings can be taxed twice, first at the corporate level and again when they are distributed to stockholders as dividends.

The double tax can be avoided by retaining earnings in the corporation

rather than distributing them as dividends. This must be carefully planned, however, since the IRS can penalize a corporation for excessive accumulation of earnings. The penalty can be avoided only if a corporation can demonstrate that it has good business reasons for accumulating earnings.

Even if you own a small business, you can gain certain tax advantages from incorporating. For example, corporate tax rates on the first \$75,000 of income are often lower than personal income tax rates.

Here's how corporate income is taxed:

CORPORATE INCOME	TAX RATE
\$0 - \$50,000	15%
\$50,000 - \$75,000	25%
\$75,000 - \$100,000	34%
\$100,000 - \$335,000	39%
\$335,000 - \$10,000,000	34%
\$10,000,000 - \$15,000,000	35%
\$15,000,000 - \$18,333,333	38%
Over \$18,333,333	35%

Your choice of a legal form for your business can have far-reaching consequences on your income taxes. It's best to consult your accountant before you make that important decision.

Getting Around a Price Increase

Most price increases are the legitimate result of rising costs. However, if you feel that a supplier's price increase is excessive or unwarranted, consider the following actions.

Place your next order at the old price. Many suppliers will accept your order rather than risk losing you as a customer.

Negotiate a reduced increase. A good rule of thumb is to ask for a one-third reduction in the increase.

Refuse to accept the increase. Tell the supplier you'll order at the old price or not at all. This is a risky approach that might lead to the loss of a good vendor, so use good judgment.

