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Tax adviser says state continues to squeeze business

George Paulsen is the partner in charge of Hood & Strong LLP's tax department. For more than 30 years, Paulsen has focused his tax planning services on businesses, including real estate developers, construction companies, franchisors, wholesale and distribution companies, and technology companies. Paulsen has also been active as a financial adviser to high net worth individuals. Below is an edited version of an interview with him.

Q: What legislation or proposed rule changes are you watching?

A: One involves the ability of businesses in California to apply net operating losses to previous and future tax years. In what's known as a "carryback," a business can apply part of a current loss to a previous tax year and receive a refund. This enables the company to gain working capital to stay afloat in the difficult year. In what's called a "carry forward," the business can apply part of the loss to future tax years, to lower tax bills during times when revenue is expected to be better.

For the past two years, this has been suspended in California for businesses with taxable income more than $500,000. Currently, a loss being carried forward from a previous year will be allowed. This has been a business stimulant in hard times, and helped business that might have gone bankrupt by enabling them to use prior tax dollars for working capital. In the past, the law penalizes the companies by deferring use of these deductions. This is one of the reasons my clients are looking to move parts of their businesses outside California. To keep businesses in the state, California has to work to lower state taxes.

Q: What advice do you offer to people forming companies?

A: Early on, set up thorough systems for sales and payroll tax and all government reporting. It can get really bad, really quick. If you don't pay payroll tax, for example, the penalty is 25 percent. Whatever it takes, get it set up and get it right. The government oftentimes doesn't come after a company until that company owes a very big bill. Keep good records. When a company gets going, some owners are writing checks everywhere to make things happen. Make sure your relations with all your stockholders are in order. Have agreements among the company founders. If all hell breaks loose down the road, where do you turn? You turn to those agreements.

Q: What about companies that are preparing for an IPO, or for a sale?

A: It goes back to the same things. Clean up your records. A lot of times there are skeletons in the closet that have been around for a while like loans to stockholders. Also take note of liabilities such as unresolved Internal Revenue Service audits, unpaid taxes or potential lawsuits. Such items are dealbreakers at the 11th hour.

Q: What's behind the state use tax?

A: It's not a new concept, but with the budget crisis, the state is picking up enforcement efforts. The use tax is essentially sales tax, and it's exactly the same rate. If a company, for example, buys any kind of equipment or supplies online and doesn't pay sales tax on the transactions, the state is starting to ask for that money retroactively.

California is also mandating businesses that aren't required to collect sales tax to file use tax returns. So for businesses like real estate contractors and professional service providers, we are now required to file returns and report taxable purchases. For businesses that were following the law, this is just additional burden.

Q: With the change of presidential administrations, what has changed, and what changes do you foresee?

A: The new administration doesn't have to do much to raise taxes because the previous administration's laws expire after 10 years. Capital gains rates will return to 20 percent from the current 15 percent, an increase of one-third. Income tax rates for the top bracket will go back to 39.6 percent from the current 35 percent. With California's top rate of 10.55 percent, this puts wealthy taxpayers paying more than 50 percent of their taxable income. Dividends, which are now taxed at 15 percent like capital gains, will go back to the regular tax brackets. This means that people in the tax bracket of more than 28 percent will see dividend income tax more than double if Congress doesn't change the law.

Q: What are some challenges unique to family-owned businesses?

A: One is succession planning. It's crucial. There's an old saying — "perpetuate or liquidate." Families are families, with family problems. Mom and Dad who founded the company knew what it took to build, and they understand intimately everything about the business. The children, meanwhile, might have less of an understanding, or maybe a daughter has the business savvy whereas a son does not, yet he expects to be compensated and might demand an equitable share of the company if a clear succession plan isn't in place. Without a clear plan, the result can be to sell everything and divide the money because it's the only way to be fair. Maybe the company founders have to bring in outsiders. Maybe that's the only way to keep the business going.

Q: Looking ahead, what are some concerns you're hearing?

A: With business down, cash flow is the big issue. Banks are under pressure to clean up their lending, so they're being tighter with businesses and telling them they could lose their lines of credit if they don't meet certain conditions. Companies are spending a lot of time dealing with this — time they could be spending on their business — because they can't lose their lines of credit.