Should a Corporation Pay Dividends in 2010 To Take Advantage of Low Dividend Tax Rates?

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Introduction

Qualified capital gains and dividends are currently taxed at a maximum federal rate of 15 percent. The current rates are schedule to expire at the end of this year. The plan recently proposed by the President would extend the current rates through December 31, 2012. It is anyone's guess whether the President's proposals will be accomplished in Congress this year. If there is no action on Capitol Hill, the maximum federal rate on net capital gains will go up to 20 percent in 2011. Additionally, the rate on all dividends will shoot up from 15 percent to the regular income tax bracket rates, potentially reaching 39.6 percent. Even if Congress approves the President's proposals, tax rates would be scheduled to increase January 1, 2013, so the analysis below would still be a worthwhile exercise.

When the tax cuts expire, many investors will be taking action on sales and dividends before the end of this year before the rate increases. Whether a corporation should pay dividends in 2010 (or by the end of 2012, if applicable) to take advantage of low rates depends on whether paying dividends will ever be beneficial.

For a C corporation, the answer depends on whether the corporation needs to pay the dividend to save accumulated earnings or personal holding company tax and, ultimately, whether the shareholders need the cash.

For an S corporation that had been a C corporation and retained earnings and profits (E&P), the answer depends on whether the shareholders need a distribution in excess of AAA ("Accumulated Adjustments Account" -- similar concept to E&P applicable to net earnings since becoming an S Corp — IRC Section 1368(e)) or have excess passive income issues.

C Corporation

If a corporation appears headed for an accumulated earnings tax problem, then one should consider accelerating dividends to take advantage of current low rates. Additionally one should consider an S election as a better solution, because S corporations are not subject to that tax. But, of course, corporate structure or exposure to built-in gain tax often precludes the S election strategy. Personal holding tax is a year-by-year calculation, so only short-term planning would be available to address it. Details about accumulated earnings and personal holding company taxes are beyond the scope of these materials.

Whether the shareholder needs the cash is more of a matter of when. If the shareholder plans to hold the stock for a long time, then the shareholder can get capital gains rates on the sale of stock or liquidation of the corporation, although remember that the latter risks double taxation on any growth in reinvestments of accumulated dividends.

S Corporation With E&P

If you have an S corporation with E&P that earns excess passive income, you are at risk for imposition of a tax. If the situation lasts too long, then you are at risk of the S election being terminated.

One solution is to distribute E&P. An election can be made to have all distributions come first from E&P and then, when E&P are exhausted, from AAA. The corporation can even declare a deemed dividend of E&P to practically guarantee that no E&P remain. If such a strategy is pursued, 2010 might be the last chance to get rates this low (or by the end of 2012, if the President's proposal is enacted).

Another solution is to generate sufficient non-passive gross receipts. Non-passive gross receipts would include an active business or active rental real estate ("passive" has a different definition here than it does for the Code § 469 passive loss rules). Some people stop here, because clients say that they have sold their business and do not want to run another one. However, gross receipts attributable to an active business run by someone else would also work. The most common example is oil and gas partnerships. When an S corporation just has marketable securities, experience suggests that investing only 2-3% of the portfolio in oil and gas partnerships will do the trick.

Therefore, although distributing the corporation's E&P is technically sound, as a practical matter investing in oil and gas partnerships often is much less expensive than paying tax – even at current low rates – on a dividend that cleanses a corporation with substantial E&P.

Conclusion

Paying dividends now to take advantage of low dividend tax rates has its merits, but consider alternatives to see whether that strategy truly measures up. The clock is ticking!

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