

Tending Shop - Looking at Distribution of Corporate Earnings

Owen E. McCafferty, CPA, CVPM, DABFA

Looking back to the mid-70s, the 80s and the very early part of the 1990s, corporate tax rates were very attractive with a graduated benefit afforded to small business taxpayers. In order to fund the ever-growing deficit, the government decided that it would attempt to tax those individuals with the least amount of political clout and the greatest dollars. Therefore, they looked at taxing persons in service corporations who are in designated and clearly discriminating activities where Congress thought it would lose the least amount of votes. They attacked those persons primarily in professions. Those engaged in the field of law, health, architecture, other healthcare services, and even those in the consulting performing arts (not in professions) were subject to a corporate tax that was as punitive as could be imagined – the same tax rate that General Motors, Ford, General Electric, etc. pay - the 35.0% tax bracket.

Many of you remember that we fought valiantly to distinguish between veterinary medicine as a profession from veterinary medicine as a personal service corporation for purposes of tax rate variance. We lost; the dark side won; and the effective tax rate for Subchapter C corporations was the highest possible bracket. Veterinary medicine, as all other professions, was denied the lower rate afforded a normal small business.

Strategies in taxation changed. No longer could earnings be accumulated to improve operations. Many practices decreased their expansionist opportunities because of this high significant tax cost.

Since that time, the government has tried to make amends by offering incentives for capital investment in tangible personal property with a plethora of tax act changes directed at the depreciation schedules. Even so, these relief provisions had no bearing in allowing other forms of capital improvement such as in the areas of tangible realty, acquisition of leasehold improvements, retirement of existing debt, etc. For all these issues, the taxpayer was left to his/her own devices to save with an onerous and punitive 35.0% tax rate.

The theory of the tax change and the high corporate tax rate assessed to professionals was that all professionals take earnings from the conduct of the profession out in salaries. That argument worked at the IRS policy-writing level for only one year. Then, the IRS started to exercise its Draconian efforts in excess compensation issues. Generally, closely-held Subchapter C corporations traditionally maximized salaries to officers/shareholders to reduce taxable

income. The Code Section relied upon was that favorite, all-inclusive Section - Section 162. The IRS has always had at its disposal the opportunity to challenge the reasonableness of salaries indicating that a portion of the shareholder's salary should be considered non-deductible as a constructive dividend if it was excessive or unreasonable. The operative words there are "excessive" and "unreasonable".

Many of you have been audited by the IRS where the issue of excessive or unreasonable compensation was raised. The very theory of a personal service corporation would preclude that argument, yet this did not stop the government from still alleging that which they had heretofore denied. Consistency is not part of the regimen in administration of the federal tax system. This inconsistency is especially seen when taxpayers are under audit. The government will take opposing situations among different types of taxpayers all for the advantage of trying to raise additional capital. Let's face it; the business of the government is to collect taxes. The government's effort is not to reduce taxes, but merely to provide the veil that the system is allegedly fair. Nothing could be further from the truth.

In 2003, Congress did have some sense (a comment that has often raised a question). The Jobs Growth Tax Relief Reconciliation Act of 2003 allowed for dividends to receive a very favorable 15.0% tax rate for individuals in the 28.0%, 33.0%, and 35.0% brackets. This rate was even lower (5.0%) for individuals in the 15.0% and 10.0% brackets (in 2008, those individuals in the 15.0% and 10.0% brackets will literally pay no taxes on dividend distributions).

All of this provides a great opportunity. Apart from our ranting and ravings about the unfairness of the tax system, there is wisdom in assessing now the determination if dividends in a Subchapter C professional corporation should be paid. Incentives to pay dividends include: an argument against accumulated earnings tax under Section 531. An accumulated earnings tax is assessed if the accumulated earnings and profits of any Subchapter C corporation are retained in treasury beyond a business's reasonable needs. There are certain calculations, such as the Bardahl formula (from Bardahl Oil) that may be needed to justify capital needs for earnings and profits. Practices with accumulated earnings and profits should make every effort to determine if dividends should be declared to mitigate the possibility of this issue being raised. Paying dividends will not completely absolve a practice with high accumulated earnings and profits from the accumulated earnings and profits tax from being posed as an issue but do provide a good defense for credibility.

Another idea may be to transfer some common stock, especially non-voting common stock, in a Subchapter C corporation to individuals in a lower tax

bracket, such as parents or children above the age of 14 where state law will permit non-DVMs, DDSs, CPAs, JDs, MDs, etc. to own corporate shares. Some states, such as Ohio, will allow non-CPAs to own minority interests. Other states will allow non-DVMs to own either small minority interests or even large interests. Each state has its own rules. Each practice board must be consulted to determine whether non-DVM ownership is permitted in that state or commonwealth. In the event that it is, transfers to family members of non-voting stock may be a consideration. We have done so with some practices rather favorably.

Excessive earnings and profits can cause problems with a second type of tax: a personal holding company tax imposed under Section 541. Passive income such as interest, dividends, royalties, and sometimes rental income can be classified as personal holding company income and can be somewhat detrimental to the tax rate structure of a practice. In fact, when assets are sold from corporations, the personal holding company tax may be an extraordinarily difficult complication. All of these factors are mitigated but not reduced completely by the habit of making dividend payments.

Recommendation

If your practice has accumulated earnings and profits in a Subchapter C format, dividends should be considered. First of all, dividends are returns on investment. Secondly, because of the lower tax rate, the temptation to declare dividends and help reduce some of these other features is great.

Many of you know I have written separate correspondence to our continuing clients urging specific clients to consider declaring dividends. In all instances, explore the wisdom of accumulated earnings being reduced through the declaration of annual dividends.

We are as far away as the phone if you have questions.

Sincerely,

OWEN E. McCAFFERTY, CPA, INC.

Owen E. McCafferty, CPA, CVPM, DABFA

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