"TAX TIPS: Dividends are a key planning item"

Carl J. Grassi | Saturday, June 6, 2015

There are many reasons corporations decide to not pay dividends to shareholders. Uncertain economic conditions have led many businesses to conserve cash over the last decade.

Beginning in 2013, dividend rates increased by almost 60% for some taxpayers, from an all-time low of 15% to the current 20% (23.8% for those taxpayers subject to the net investment income tax).

This increase provided an additional incentive for corporations to hold on to cash, because a distribution of earnings via a dividend is not deductible by the corporation and therefore represents the classic “double tax” scenario to which C corporations are subject.

The IRS, however, does not like it when corporations hold onto their cash, and can impose a penalty tax for doing so.

Many business owners are surprised to learn that the IRS can effectively compel them to make nondeductible dividend distributions.

If a determination is made that the business is accumulating earnings to avoid the tax payable on dividends, the IRS can impose an “accumulated earnings tax” on the corporation, at the same rate imposed on dividend income.

This is a penalty and is not reported by the taxpayer; it only comes up on audit when the IRS examiner determines that the corporation has accumulated more than a reasonable amount of earnings for the corporation's business needs.

Once the IRS examiner asserts that there is an unreasonable accumulation of earnings, the burden is generally on the taxpayer to show that such accumulation was reasonable given the needs of the business.

The tax can be avoided if the corporation can show that the accumulation is not to avoid paying dividends, but to prepare and provide for legitimate business reasons such as the expansion of a facility, acquisition of another business or debt retirement, among other reasons.

It is necessary for the business needs to have been in existence at the end of the year under audit; the corporation cannot “create” needs once the audit comes up and assert that these needs were present in the year under audit.

It is therefore important to document these needs each year, ideally in the minutes of the shareholders' or directors' meeting. It is much more convincing to show an examiner minutes of a year-end meeting during which it was resolved to set aside funds for the eventual redemption of a significant shareholder (for instance) than it is to convince the examiner during an audit several years later that this was the reason for the accumulation.

The company is also allowed to retain a sufficient amount of earnings to provide working capital to the business.

Many years ago, the U.S. Tax Court established a formula known as the Bardahl formula, for determining the amount of working capital needed for this purpose. This formula takes into account the capital needed for the business by looking at the business operating cycle and the cash needed to operate the business for a taxable year.

An audit on the accumulated earnings issue can be time consuming and expensive, and because the issue of “reasonable needs” is subjective, it is better to avoid this issue in the first place.

A solid history of paying significant dividends can help avoid this issue. Loans to shareholders should be very carefully considered (or avoided altogether) because they may be viewed as a non-taxable substitute for paying taxable dividends.

Finally, an S corporation election will provide complete relief prospectively because S corporations are not subject to the accumulated earnings tax, although the corporation would remain subject to audit for prior years' accumulations.

Because of the many factors that go into the analysis, it is important to have a comprehensive plan that takes into account (and documents) the needs of the business, from both a working capital and a future needs basis, along with establishing a dividend paying policy.

The amount of IRS attention to this issue has varied over the years. This was a significant issue in prior years when capital gains were taxed at a rate that was lower (and in some cases much lower) than dividend rates.

It seems as though the IRS was less likely to focus on this issue in more recent years when dividend rates were very low. With the recent increase in dividend rates, this issue will be coming up more frequently in audits and should therefore again be an important planning item for corporations.

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