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Post-JGTRRA Dividend Planning

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The JGTRRA reduced the tax rate on dividends for individuals and lowered the accumulated earnings and personal holding company taxes for corporations until 2008. This article reviews some of the planning techniques corporations and shareholders can use to take advantage of the temporarily lower rates.

One of the key provisions of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), if not the prime emphasis of the legislation, is Section 302's reduction in the individual tax rate on corporate dividends received to 15% (5% for individuals in the 15% and 10% brackets). In an emerging trend, the lower tax rates on dividends will sunset in 2008. This six-year window affords some interesting planning opportunities for both C and S closely held corporations that want to reduce their accumulated earnings and profits (E&P). This article discusses some of the dividend planning opportunities under the JGTRRA for closely held corporations and their shareholders.

Background

The bane of corporate taxation has always been the double taxation of corporate earnings. Because of this, most closely held corporations (usually C corporations) have been loathe to distribute dividends, and have also planned to avoid constructive dividends. Consequently, many C corporations (and some S corporations that were previously C corporations) have

locked-up E&P that, in post-2008 years, can generate a second level of tax to shareholders at pre-2003 tax rates.

Example: X, a C corporation (not a personal service corporation), has \$1 million taxable income and distributes its entire after-tax earnings as a dividend to its sole shareholder Y, whose marginal tax bracket is 35%.

	Pre-JGTRRA	Post-JGTRRA
<u>X</u>		
Taxable income	\$1,000,000	\$1,000,000
Corporate tax rate	34%	34%
Corporate tax	\$340,000	\$340,000
After-tax earnings	\$660,000	\$660,000
<u>Y</u>		
Dividend distribution	\$660,000	\$660,000
Individual tax rate	35%	15%
Individual tax	\$231,000	\$99,000
<u>Combined X and Y tax</u>	\$571,000	\$439,000
Combined effective tax rate	57.1%	43.9%
Combined tax savings		\$132,000
Combined rate change		13.2%

For some taxpayers, this may be an opportune time to "bail out" E&P at this lower tax rate. Of course, it is unknown whether the law will become permanent.

New Dividend Tax Rate

JGTRRA Section 302 reduces the individual tax rate for qualified dividends received to 15% and to 5% for individuals in the 15% and 10% brackets, for dividends received in tax years beginning after 2002 and before 2009.¹ For 2008 only, the tax rate on qualifying dividends for individuals in the 15% or 10% bracket is reduced to zero. The change in the dividend tax rate applies only to individuals, not corporations.² Sec. 1(h) shows how to calculate the tax on dividends, which are included with adjusted net capital gains under Sec. 1(h)(3) and taxed at the 15% capital gain rate. However, under Sec. 1(h)(3)(B), capital losses cannot offset dividend income.

Only qualified dividends are eligible for the reduced rates. Under Sec. 1(h)(11)(B)(i), qualified dividends are "dividends received" from domestic corporations³ and qualified foreign corporations. Unfortunately, the JGTRRA and the Committee Reports do not provide a definition of a "dividend" and do not expound on "received." However, dividends are defined generally in Sec. 316(a) as property distributions that a corporation makes to its shareholders out of E&P. Presumably, constructive dividends will be qualified dividends subject to the lower tax rate; however, this is not certain until regulations are promulgated. Qualified foreign corporations include corporations incorporated in a U.S. possession, foreign corporations eligible for benefits under a tax treaty with the U.S. and foreign corporations whose

stock is readily tradable on an established U.S. securities market.⁴

Special rules under Sec. 1(h)(11)(D)(i) exclude otherwise qualified dividends to the extent a taxpayer takes the dividend into account as investment income for purposes of the Sec. 163(d) investment income limit. Other special rules deal with extraordinary dividends under Sec. 1059 and dividends received from regulated investment companies and real estate investment trusts under Sec. 1(h)(11)(D)(ii) and (iii).⁵

Dividend Planning— Bailing Out E&P

The goal in most of the planning techniques discussed below is to distribute earnings in certain cases as dividends during the period of lower tax, to avoid (1) a higher rate in a future year or (2) future dividend potential, by reducing (or even eliminating) E&P. This is not an all-inclusive list; hopefully, it will help spark other ideas. It should also encourage tax advisers to reexamine their C or S clients with accumulated E&P for possible dividend distribution opportunities.

Compensation Issues for C Corporations

Closely held C corporations have traditionally maximized salaries to officer-shareholders to reduce corporate taxable income. Under Sec. 162(a)(1),⁶ the Service often seeks to treat a portion of a shareholder's salary as a nondeductible construc-

¹ This is a brief summary of the change in law for dividends received by individuals; it is not intended to cover all provisions of the new dividend tax rate.

² Dividends received by corporations from domestic corporations can qualify for the Sec. 243 dividend-received deduction. Corporations can exclude 70% of dividend income (100% in certain cases of affiliated groups).

³ Excluded from the definition of qualified dividends are dividends received from tax-exempt entities under Secs. 501 and 521, any amount allowed as a deduction under Sec. 591, dividends described in Sec. 404(k), dividends subject to the Sec. 246(c) holding periods (as modified) and

dividends received from certain foreign corporations (foreign personal holding companies, foreign investment companies and passive foreign investment companies).

⁴ See also the discussion below under "Foreign Dividend Planning."

⁵ A thorough discussion of these topics is beyond the scope of this article.

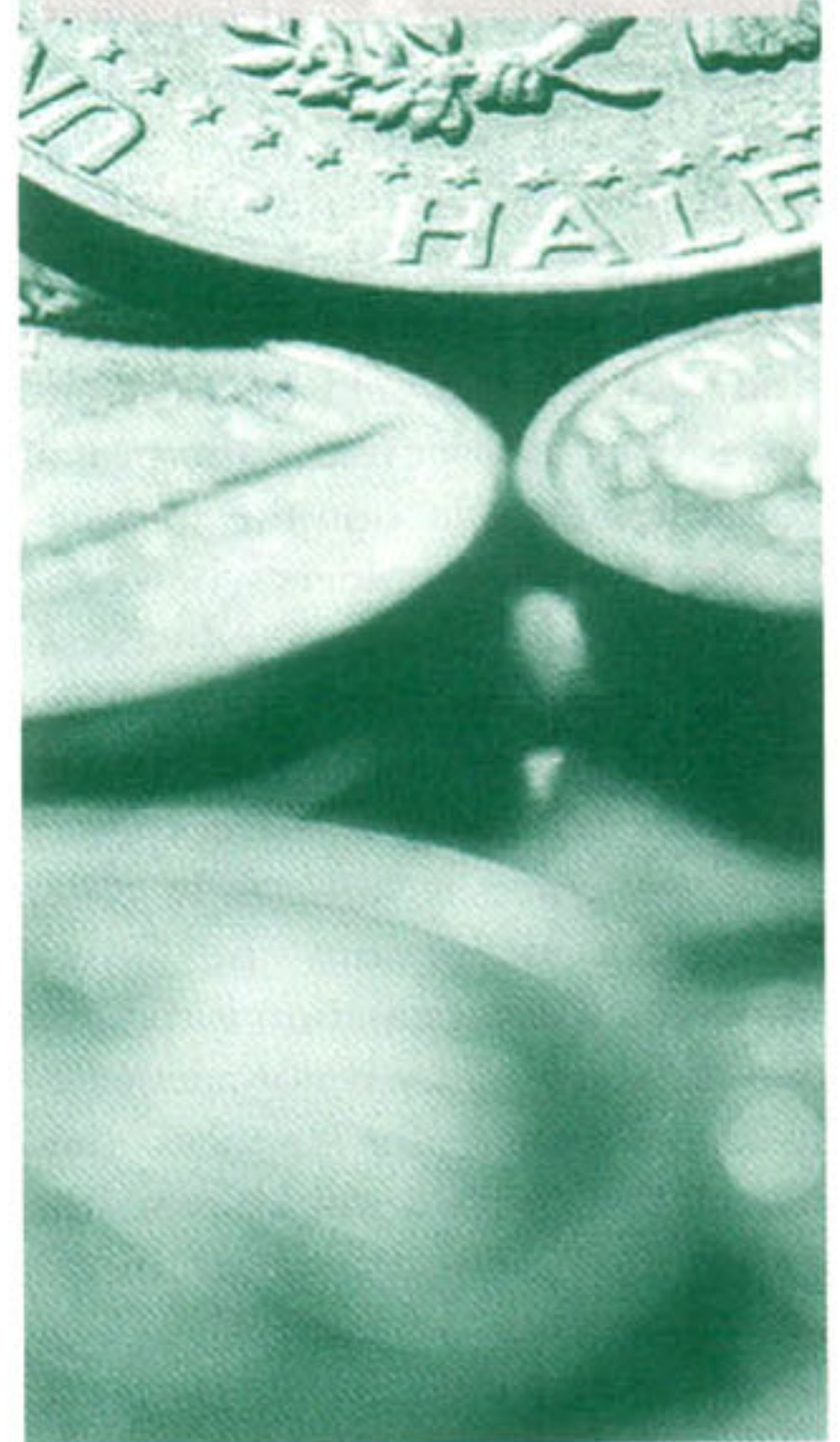
⁶ Sec. 162(a) allows "as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including (1) a reasonable allowance for salaries or other compensation for personal services actually rendered...."

EXECUTIVE SUMMARY

■ **E&P can be distributed as dividends during the JGTRRA period of lower tax to avoid higher tax in a future year.**

■ **Corporations with accumulated E&P and PHCI should consider paying dividends to shareholders in the 10% and 15% brackets.**

■ **The lower dividend rates also affect traditional planning strategies, such as compensation, shareholder advances, Sec. 302 redemptions and Sec. 306 preferred stock transactions.**



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tive dividend if there is evidence that it is excessive or unreasonable. Prior to the JGTRRA, because salary and dividend income were taxed at the same rates, a successful unreasonable compensation issue would garner corporate-level tax, with no meaningful mitigating effect on the individual shareholder.⁷ If the disallowed compensation is accorded constructive-dividend treatment (and constructive dividends are considered qualifying dividends eligible for the lower tax rate), the reduced JGTRRA dividend tax rate should lessen the effect of the unreasonable salary disallowance.

In certain cases, closely held C corporations that want to reduce E&P should consider paying dividends, rather than salaries. From the shareholder's perspective, a dividend might be preferable over compensation, due to the reduced income tax rate (especially if he or she is in the 10% or 15% bracket) and the elimination of FICA and Medicare taxes. From the corporation's vantage point, it could also save corporate-level FICA and Medicare taxes; however, the corporate compensation deduction would be lost. The tax adviser must consider the overall combined tax effect on the corporation and the shareholders when converting compensation to a dividend. Paying some dividends rather than salary might be cost effective, especially in tax years when corporate taxable income is sufficiently offset by other deductions or losses. However, if compensation is too low and the shareholder is not adequately compensated for services rendered, the Service could raise the unreasonably low salary issue. In this reverse setting,⁸ additional employment taxes would be assessed and there would be a higher income tax

on compensation as well.

Salary history becomes an important factor when evaluating reasonable compensation cases. Lowering salary in pre-2009 years may establish an unfavorable precedent for post-2008 years, when higher payments may be beneficial. Further, reducing compensation can have a major effect on retirement plans and other fringe benefits, which need to be taken into account when reducing compensation in favor of a dividend distribution.

Accumulated E&P

Sec. 531 provides an additional tax on a corporation's accumulated taxable income, equal to the highest individual tax rate. The accumulated earnings (AE) tax is essentially a penalty tax for accumulating E&P beyond the business's reasonable needs. The statute's intent is to penalize a corporation for avoiding a second level of tax at the shareholder level by retaining income, rather than paying dividends.

Under JGTRRA Section 302(e)(5), the Sec. 531 AE tax rate was lowered to 15%. This rate is currently effective for tax years beginning after 2002 and before 2009. In 2009, the AE tax rate will revert to 35%. Except for individuals in the lower 10% or 15% tax brackets (in which dividends are taxed at 5%), the corporate-level AE tax equates to the dividend-level tax at the shareholder level.

Corporations that may have exposure to the AE tax and want to avoid the time and expense of defending against it, should pay some level of dividends to avoid it. The JGTRRA should encourage corporations to pay dividends in this context to take advantage of the lower dividend tax rates. It would be par-

ticularly beneficial to pay dividends to shareholders in the 10% and 15% brackets, in which the dividend tax rate is 5% (0% in 2008).

Family Transfers of Stock

One planning strategy is to transfer shares to family members in the 10% or 15% bracket, followed by dividend distributions to take advantage of the 5% rate (0% in 2008). The stock must meet a 60-day (120-day for preferred stock) holding period provided in Secs. 1(h)(11)(B)(iii) and 246(c). Further, in certain circumstances, the lowering of the long-term capital gain rate to 15% (5% for taxpayers in the 10% and 15% brackets; 0% for 2008) may make a sale of stock preferable to a gift. The tax planner must compare the value of a basis step-up against the use of the unified estate and gift tax credit when evaluating a sale versus a gift. The sale must be at fair market value (FMV) to avoid gift tax implications and the purchase price must be funded. Thus, a sale to a child without his or her own financial resources may require the parents to either gift or advance cash to the child to fund the purchase price. Installment-sale reporting may also be available.

Further, a client may be reluctant to sell property and incur a tax when the property can be held indefinitely and the tax postponed. Also, the Sec. 1(g) "kiddie tax" rules must be considered in calculating any tax savings. The client must evaluate this strategy in conjunction with his or her overall estate plan.

PHCs

Sec. 541 imposes an additional corporate-level tax on corporations with undistributed personal holding company income (PHCI). In gener-

⁷There is a potential for an employment tax refund because of the recharacterization of salaries to dividends. However, in some cases, the IRS will maintain that the salary is disallowed as unreasonable under Sec. 162(a)(1), but will not treat the disallowed amount as a constructive dividend to the shareholder, so it will not affect employment taxes. Thus, it remains as compensation at the shareholder level. There is judicial support for disallowing compensation to a corporation as unreasonable without characterizing the

receipt of the payment as a constructive dividend. Unless the IRS asserts constructive-dividend treatment, the payment will remain as compensation in the hands of the employee-shareholder; see *Stern Sales Corp.*, 345 F.2d 552 (Ct. Cl. 1965).

⁸The Service typically raises this issue for S corporations that pay unreasonably low salaries to avoid employment taxes; see Rev. Rul. 74-44, 1974-1 CB 287 and *Spicer Accounting, Inc.*, 918 F.2d 90 (9th Cir. 1990).

al, under Sec. 543(a), PHCI is passive income (e.g., interest, dividends, royalties and sometimes, rental income). Similar to the AE tax, this tax penalizes a corporation for not paying dividends. The PHCI tax is imposed at the highest individual tax rate, in addition to the corporate income tax. To avoid the onerous PHCI tax, corporations can pay dividends from undistributed personal holding company income (UPHCI). The dividend payments reduce UPHCI and, thus, minimize PHCI tax. JGTRRA Section 302(e)(6) reduced the PHCI tax rate to 15%. As with the AE tax, corporations subject to the PHCI tax should consider paying dividends prior to 2009 to shareholders in the 10% and 15% brackets, to take advantage of the 5% rate.

Shareholder Advances

A corporation's loans to shareholders run the risk of being treated as constructive dividends, especially when they lack certain formalities (e.g., a written note, stated interest, collateral or a definite term) and there is little likelihood that they will be repaid.⁹ This is a highly factual and much-litigated area that requires research and planning. Whether an advance to a shareholder is a loan or a dividend is generally determined at the time of the advance.¹⁰ Repayments of the loan or advances may be a positive factor in establishing that the loan is a true loan and not a constructive dividend.¹¹

When there is concern that a shareholder will be unable to repay the loan or make meaningful reductions in the loan balance, the low dividend tax rates may offer some solutions at a reduced shareholder cost. For example, the corporation may issue a cash dividend to the shareholder, who in turn uses the proceeds to repay the loan. When the corporation does not have the funds

to pay a cash dividend, the loan (i.e., the note) may be distributed to the shareholder/debtor as a dividend. A dividend distribution allows the shareholder to repay the loan at a low tax cost and also reduces corporate-level E&P.

Some corporations convert shareholder loans into compensation at year-end to reduce the loan balance. When corporate deductions are not critical, a dividend distribution, rather than compensation, should be considered, because of the lower dividend rate and lack of employment taxes. Again, however, the effect on retirement plans and fringe benefits must be evaluated if compensation is to be reduced. Further, reducing the loan balance through a dividend payment when rates are lower may signal that the original loan was potentially a dividend when made.

S Corporations with E&P

S corporations that were formerly C corporations, or S corporations that merged with a C corporation, may have accumulated E&P from their former C years. Because of the reduction of the dividend tax, the S corporation, with the consent of all its shareholders, may want to consider making a Sec. 1368(e)(3) election to have distributions paid from E&P before the accumulated adjustments account (AAA).

S corporations that have passive investment income (PII) in excess of 25% of gross receipts and have accumulated E&P at the close of a tax year may be subject to the PII tax under Sec. 1375. The Sec. 1375 tax is levied at the corporate level at the highest corporate tax rate (currently, 35%) and results in double taxation. To avoid that tax, S corporations subject to it should consider distributing a dividend (using the Sec. 1368(e)(3) election) to eliminate accumulated E&P before the tax year closes.

Further, and maybe more importantly, an S corporation may lose its S status when it has accumulated E&P and PII exceeding 25% of its gross receipts for three consecutive tax years, under Sec. 1362(d)(3). Thus, a timely elimination of E&P through a dividend distribution may also avoid S termination. S corporations facing termination due to excess passive income should strongly consider making dividend distributions using the Sec. 1368(e)(3) election, so that distributions are deemed made from E&P before the AAA.

Sec. 302 Redemptions

Tax advisers typically plan to avoid dividend treatment when structuring stock redemptions involving family members, especially in business succession planning. In general, under Sec. 302, a distribution in redemption of stock will be treated as a sale or exchange of the stock, rather than a dividend, if (1) the redemption is not essentially equivalent to a dividend (Sec. 302(b)(1)); (2) there is a meaningful reduction in the shareholder's stock holdings under the substantial disproportionate percentage tests (Sec. 302(b)(2)); (3) there is a complete termination of a shareholder's interest (Sec. 302(b)(3)); and (4) in certain partial liquidations (Sec. 302(b)(4)).

Sale or exchange treatment usually results when a shareholder has terminated his or her entire stock interest in a Sec. 302(b)(3) stock redemption. However, the family attribution rules under Sec. 318(a)(1) can prevent a shareholder who has sold his or her entire stock interest from qualifying under Sec. 302(b)(3). The redemption proceeds would be treated as a dividend, rather than a sale or exchange qualifying for capital gain treatment. However, a redeemed shareholder may waive the

⁹ On a related matter, when there is a below-market shareholder loan under Sec. 7872(c)(1)(C), the forgone interest treated as a dividend to the shareholder under Prop. Regs. Sec. 1.7872-4(d) should be taxed at the new dividend tax rates. However, this will not be certain until dividends are defined

in regulations.

¹⁰ See *Ralph D. Crowley*, 962 F.2d 1077 (1st Cir. 1992).

¹¹ See *Theodore C. Miller*, TC Memo 1980-445; *In re Clement Betpouey*, Bank Ct., ED LA, 9/3/98.

family attribution rules under Sec. 302(c)(2) and, thus, achieve sale or exchange treatment. Under this provision, the redeemed family member may not maintain any continuing interest in the corporation (including an interest as an officer, director or employee), other than an interest as a creditor. These restrictions can create limits and stress when the redeemed shareholder's services are valuable to the business, especially in a family succession situation.

Under the JGTRRA, long-term capital gains and dividends are taxed at the same 15% rate. Thus, because avoiding dividend treatment is not as critical, the redeeming shareholder may not want to be bound by the family attribution waiver and can continue to serve the corporation during the transition period. However, because a dividend does not involve a sale or exchange, there is no offset of the income for the shareholder's basis in the stock; this may not be a material issue if the shareholder has low-basis stock. The good news, however, is that the IRS issued proposed regulations in October 2002 that permit the redeeming shareholder to maintain stock basis when the redemption is treated as a dividend.¹²

Preferred Stock under Sec. 306

A sale or redemption of preferred stock issued in a tax-free distribution by a C corporation may result in ordinary income to the seller if the preferred stock meets Sec. 306 requirements (Sec. 306 stock).¹³ The JGTRRA clarifies under Sec. 306(a)(1)(D) that ordinary income derived from a sale (other than a redemption) of Sec. 306 stock is a dividend for purposes of the reduced tax on dividends. For a redemption, Sec. 306(a)(2) provides that the

amount realized will be treated as a property distribution to which Sec. 301 applies.

Prior to the addition of Chapter 14 (Secs. 2701–2704) in 1990, tax-free distributions of preferred stock under Sec. 305 were commonly used in estate and business succession planning, to shift a corporation's growth component to family members and thereby affect a valuation freeze. A sale or redemption of Sec. 306 stock results in ordinary income and is treated as a dividend. If the preferred stock is transferred as a gift, the ordinary taint under Sec. 306 is transferred to the donee under Sec. 306(c)(1)(C), creating ordinary income potential on a donee's sale.

To avoid ordinary income, a shareholder can hold the Sec. 306 stock until death, or a donee can dispose of the stock in a transaction that qualifies for capital gain treatment under Sec. 306(b).¹⁴ To reduce E&P, holders of Sec. 306 stock may either want to redeem or sell it, thus triggering dividend income at the 15% rate. For a disposition other than a redemption, any basis not used (because of the dividend treatment) will transfer to other common stock held by the shareholder.¹⁵ For a redemption, Prop. Regs. Sec. 1.302-5 should preserve any unused basis.

For C corporations that plan to issue preferred stock in a tax-free distribution, the Sec. 306 ordinary income taint will not attach to the stock if the corporation has no E&P as of the close of the tax year in which the stock was issued.¹⁶ Thus, it may be advisable to distribute all E&P (both current and accumulated) just prior to the issuance of the preferred stock and the close of the tax year. Any future sale or redemption of the preferred stock, especially after the JGTRRA's expiration

date, would be taxable as long-term capital gain.

Distribution of C Corporation's Assets

As a traditional planning tool to avoid double taxation for C corporations, assets subject to appreciation (e.g., real estate) are frequently owned by shareholders and leased to the corporation. However, if the C corporation owns assets that may be better positioned in the shareholders' hands, the JGTRRA provides some planning opportunities. Under certain circumstances, this may be the time to distribute these assets to shareholders as a dividend.

Under Sec. 311(b)(1), a corporation's distribution of appreciated property to a shareholder is a sale, resulting in potential taxable gain at the corporate level. The gain is the difference between the property's FMV and its adjusted tax basis; a loss is not recognized, under Sec. 311(a). Under Sec. 312(b), E&P is increased to the extent of any gain recognized. If the distribution results in a dividend to the shareholder, the dividend is the property's FMV on the distribution date. Under Sec. 301(d), the property's adjusted basis will be its FMV.

C corporations with high-basis assets, such that a distribution would result in minimal corporate gain, may want to consider distributing them as a dividend, to shift any future appreciation to the shareholder and avoid future double taxation on an eventual sale of the property. The dividend would be taxable at the new lower dividend rates, with a corresponding basis step-up to FMV for the shareholder. Also, C corporations with net operating losses or unused capital losses (especially if the capital losses are about to expire)¹⁷

¹² See Prop. Regs. Sec. 1.302-5. A complete discussion of these proposed regulations is beyond the scope of this article; however, in general, a loss can be recognized for the remaining stock basis if specified criteria are met.

¹³ This is commonly referred to as the "Sec. 306 taint."

¹⁴ See Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* (Warren, Gorham & Lamont, 7th ed., 1994), ¶8.65 (e.g., a termination of a

shareholder's interest would qualify under Sec. 306(b)).

¹⁵ See Regs. Sec. 1.306-1(b)(2), *Example 2*.

¹⁶ See Secs. 306(c)(2) and 316(a)(2).

¹⁷ Corporate capital losses can be carried back three years and forward five years, under Sec. 1212.

Tax advisers should reexamine their C and S clients with E&P for possible dividend distribution opportunities.

available to offset any corporate-level capital gain under Sec. 311(b)(1) resulting from the distribution, should consider this planning opportunity. However, if the property will be depreciable in the shareholder's hands, Sec. 1239 may treat the corporation's gain as ordinary income that cannot be offset against capital losses. Under Sec. 1211, corporate capital losses are allowed only to the extent of capital gains.

Foreign Dividend Planning

Under the JGTRRA, Sec. 1(h)(11)(B)(i)(II) provides that dividends from qualified foreign corporations are eligible for the reduced 15% dividend tax rate for individuals. A qualified foreign corporation includes any foreign corporation incorporated in a U.S. possession, eligible for benefits of an income tax treaty with the U.S., or has its stock traded on an established U.S. securities market. Under Sec. 1(h)(11)(C)(iii), qualified dividends do not include dividends received from foreign PHCs (Sec. 552), foreign investment companies (Sec. 1246) and passive foreign investment companies (Sec. 1297).

Dividends received from foreign corporations raise some interesting questions. In particular, are constructive inclusions of Subpart F income by an individual shareholder of an otherwise "qualified" controlled foreign corporation (CFC) considered "received"¹⁸ and, thus, eligible for the reduced tax rate on dividends? Although not specifically defined as such,¹⁹ Subpart F inclusions are, in

some respects, "constructive dividends." Sec. 951(a)(2)(A) defines a shareholder's pro-rata share of Subpart F income as an "amount which would have been distributed with respect to the stock which such shareholder owns...." There may be some support in other Code sections, although tenuous, for the argument that Subpart F inclusions constitute dividends "received." For example, (1) Sec. 960 provides that, for the indirect foreign tax credit, Sec. 902 will be applied as if the amount included in gross income was a dividend and (2) under Sec. 961(a)(1), a shareholder's basis in his or her stock is increased by the amount of Subpart F income included in taxable income. Sec. 961(a)(1) creates the fiction that the gross income inclusion was actually received and transferred back to the corporation as contributed capital.

However, in Sec. 1248, a companion section to the Subpart F provisions, Congress expressly used the term "dividend." The IRS may argue against treating Subpart F inclusions as "dividends received," because Congress would have indicated dividend treatment directly in the statute. In general, Sec. 1248 treats certain gains from the sale of CFC stock as dividends to the extent of the foreign corporation's E&P.²⁰ Hopefully, regulations will affirmatively answer whether Subpart F inclusions can qualify for the reduced dividend tax rate.

CFCs with Subpart F income should exercise caution when making

cash distributions. Paying a cash dividend will not necessarily convert Subpart F gross income inclusions into actual dividend income. According to Sec. 959(a), actual distributions are nontaxable to the extent paid out of E&P included in gross income under Subpart F.²¹ Further, Sec. 959(d) provides that distributions excluded from gross income under Sec. 959(a) are not treated as dividends.

In a non-Subpart F context, qualifying foreign corporations may want to consider repatriating earnings in the form of dividends after the JGTRRA sunset date. Under Sec. 964(a), foreign corporations must determine E&P in the same manner as domestic corporations. Dividends paid at the 15% rate may avoid future taxation at pre-JGTRRA rates. In addition, to the extent E&P has been reduced by dividend distributions, the amount treated as a dividend under Sec. 1248 on the eventual sale of CFC stock will be reduced. Before dividends are paid from foreign corporations, tax advisers must consider the effect of any foreign withholding tax resulting from the distribution.

Conclusion

This article highlighted some planning ideas for corporate clients with E&P in conjunction with the reduced tax rate for individuals on dividends received after the JGTRRA. Tax practitioners should look carefully at their corporate clients for E&P bailout opportunities at the temporarily reduced dividend rate. There are many opportunities, but also many unanswered questions, that need to be addressed in future regulations, especially for constructive dividends and in the international context. Is now the time to bail? It may be.

TTA

¹⁸ Sec. 1(h)(11)(B) states, "the term 'qualified dividend income' means dividends received during the taxable year...." (Emphasis added.)

¹⁹ See Sec. 951(a)(1).

²⁰ Sec. 1248(b) limits on the tax paid by individuals for gains treated as

dividends.

²¹ See the *Example* in Regs. Sec. 1.959-1(b), illustrating a cash distribution's effect on taxable income in a year when there is also Subpart F income.