

## Some Cash Rich & Less Taxing Ideas for C Corporations and Their Shareholders

In terms of tax planning, since the 1986 Tax Act, C corporations have been the Rodney Dangerfield of entities. They get no respect. Nonetheless, there are billions of dollars of C corporation assets on which Michigan lawyers provide advice daily. With that enormous installed base, practitioners need to think through some planning opportunities based on the temporary 15 percent rate on qualifying dividends.

### C Corporation with Excess Cash

Historically, a dividend distribution by a C corporation was a tax disaster. In the 50 percent bracket days, it took \$2.00 of pre-tax income at the shareholder level to net one dollar. With the advent of the 35 percent bracket, that declined to about \$1.54. At the temporary 15 percent tax bracket, it takes about \$1.18 of pre-tax dividend income for the shareholder to net \$1.00. The above numbers ignore Michigan tax.

The result was that C corporations historically, for very good reasons, avoided making taxable distributions. However, today they should seriously consider doing so. Part of the reason is that the 15 percent dividend rate is scheduled under current law to expire in 2010. The better question to ask might be, depending on who prevails in the elections in 2008, given the record structural federal deficits, will the 15 percent dividend rate last until 2010? Many tax professionals do not think that it will. Raising the dividend tax rate is the Joint Committee of Taxation and other congressional committees' number one method to fund deficit reduction and raise revenues to fund AMT relief.

A simple, effective planning technique for many taxpayers is to simply make a large one-time dividend distribution. There are also some variations on this idea. In the case of a mature C corporation where the

senior generation does not want to sell, in some situations it even makes sense for the corporation to borrow money from a bank to fund all or a portion of a large, one-time distribution to shareholders. With substantial cash removed from the company, and quite possibly a liability to the bank, the stock is worth less, and that certainly has estate planning implications and may present opportunities. Another variant is a "part sale," and a large 15 percent rate distribution to shareholders. This can be arranged if the senior generation wants (a) some cash, (b) to diversify their holdings, (c) to retain control and/or (d) pass the business down the generational ladder. Among other benefits, because of the reduced fair market value of the company, it reduces gift tax complications.

Another variant on the same theme is to effect a partial management buy-out. The cash distribution again provides the owner with cash and a dividend asset base. It also makes the stock more affordable for the purchasers.

Another not uncommon situation is the C corporation with appreciated property, such as rental real estate, that did not elect S corporation status. The fear with electing generally far more favorable S corporation status is IRC 1362(d)(3)'s rule that if a C corporation converts to a S status and more than 25 percent of gross receipts are from passive sources, then it loses its S status automatically after three years if, and only if, it also has C corporation earnings and profits. The planning opportunity is to make whatever arrangements are needed to fund a one-time distribution to deplete the C corporation earnings and profits, and thus make the desired conversion to S corporation status feasible. There is a special election under Treas. Reg. 1.1368-1(f)(2) to treat distributions as first coming from C corporation earnings and profits that may be

made. This is a particularly valuable planning device for the not all that uncommon situation of either a C corporation owning primarily appreciated real estate or a C corporation that sold its operating assets but now has marketable securities.

### Conclusion

In the view of most tax practitioners, the 15 percent dividend rate is on the congressionally endangered species list and will not last much longer. Readers are advised to review the particulars of C corporation clients' factual settings and consider what planning might be appropriate to undertake at this time.



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