Changing Tradeoffs Confront Employee-Shareholders Who Want to Access Corporate Profits

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By Richard Winchester*

A n employee-shareholder of a closely held C corporation can access the earnings of the business in at least two ways. The corporation can pay the employee-shareholder compensation for any work performed for the company. It can also distribute its profits as a dividend.

In each case the business enjoys a measure of flexibility in choosing how to structure a payout. If the payout takes the form of compensation, the business can deduct the payment as long as the amount is reasonable for work actually performed. I.R.C. § 162(a)(1). It faces no no tax restrictions if it pays out earnings as dividends. To the contrary, the tax law actually penalizes a corporation that accumulates earnings beyond its reasonable needs instead of paying the profits out to shareholders. I.R.C. §§ 531–537.

Each option for accessing corporate earnings has different tax consequences to the corporation and to its employee-shareholder. Prior to the Bush dividend tax cut, the combined tax cost to the employee-shareholder and the firm was always lower if the payout took the form of compensation. However, the Bush dividend tax cut changed the math, making it more tax advantageous for a payout to take the form of a dividend in a considerable number of cases. See Richard Winchester, Working for Free: It Ought to Be Against the (Tax) Law, 76 Miss. L.J. 227 (2006). Unless the dividend tax cut is extended or otherwise made permanent, the current set of tradeoffs will expire along with the law.

This article identifies the various rules and factors that determine the total tax cost to the corporation and its employee-shareholder when a payout takes the form of compensation or a dividend. The article highlights how the expiring dividend tax cut and other scheduled changes to the law introduce a timing element into the analysis.

Compensation

If an employee-shareholder receives compensation, two sets of tax rules determine the net tax effect to the company and the individual. First, there are the income tax rules. As noted above, the corporation can deduct any amount paid out as compensation, provided that the amount is reasonable. I.R.C. § 162(a)(1). The value of this deduction will depend on the corporation’s marginal tax bracket—15, 25, 34, 35, 38, or 39 percent. I.R.C. § 11(b)(1). Therefore, the tax savings could range from 15 cents to 39 cents on the dollar.

The employee-shareholder, meanwhile, is taxed on any amounts received as compensation. I.R.C. § 61(a)(1). The recipient’s tax cost depends on his or her marginal tax bracket—currently 10, 15, 25, 28, 33, or 35 percent. I.R.C. § 1(a)–(d), (i). The same six brackets will remain in effect through 2010. Pub. L. No. 107-16, § 901(a), 115 Stat. 38.

After 2010, the existing temporary tax rate schedule will be replaced by the five marginal tax rates that were in effect before 2001. Those rates are: 15, 28, 31, 36, and 39.6 percent. I.R.C. § 1(a)–(d). The tax cost thus depends on the year in which the compensation is received and the recipient’s income level at that time.

The payment of compensation also triggers an employment tax (FICA) liability for both the business and the employee-shareholder. The employment tax itself consists of two components. The first component is the old-age, survivors, and disability insurance component, often referred to as OASDI, which is earmarked to cover Social Security benefits. It is a 12.4 percent levy imposed on amounts that constitute “wages from employment.” I.R.C. §§ 3101(a), 3111(a). One-half of that tax is deducted from the employee’s compensation. I.R.C. § 3102(a). The business pays the other half. I.R.C. § 3111(a). There is a limit on the amount of wages that can be taxed. This limit is $102,000 for 2008. Notice 2007-87, 2007-45 I.R.B. 966. The limit is adjusted annually to reflect increases in average wages of the U.S. economy. 42 U.S.C. § 430.

The second component of the FICA tax is the hospital insurance component. It is a 2.9 percent levy on an individual’s wages from employment. As with the OASDI component, one-half of this tax is deducted from the employee’s compensation, while the employer pays the other half. However, unlike the OASDI component, there is no limit on the wage base for this tax.

The employment tax increases the tax cost of any payout taking the form of compensation, but those tax costs are partially offset by income tax savings. The business can deduct its share of any employment tax paid on the employee’s compensation. I.R.C. § 162(a). As is true for the compensation itself, the value of the deduction depends on the corporation’s tax bracket. Thus, it will range anywhere from 15 cents to 39 cents on the dollar. See I.R.C. § 11(b)(1). The deduction is available for both the OASDI and the hospital insurance components of the tax.

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Dividends

If an employee-shareholder receives a dividend, the only federal tax rules to consider are the income tax rules. For the corporation, the analysis is simple because the corporation cannot deduct any dividends it pays. Nor is there a tax cost to the corporation.

On the employee-shareholder side of the equation, any dividend received is subject to tax because it counts as gross income. I.R.C. § 61(a)(7). The amount of tax depends on up to three factors: the year in which the dividend is received; the recipient’s tax bracket; and, in the case of a dividend received before 2011, the length of time the recipient held the stock.

Until 2011, dividends from stock held at least 61 days are treated more favorably than dividends on stock held for shorter periods. If the stock was held for less than 61 days, the dividend will be part of the recipient’s ordinary income, making it subject to tax at the recipient’s marginal rate. Accordingly, it will be subject to tax at one of the six rates currently in effect for 2008 through 2010 (ranging from 10 percent to 35 percent). See I.R.C. § 1(a)–(d), (i).

If the dividend is paid on stock that was held for more than 60 days, the dividend constitutes a qualified dividend. I.R.C. § 1(h)(11)(B). As such, it is taxed at the rates that apply to long term capital gains. I.R.C. §§ 1(h)(3)(B), (11)(A). For 2008 through 2010, one of two long term capital gains tax rates will apply, depending on the taxpayer’s marginal tax bracket. If the recipient is in the 25 percent tax bracket or higher, the dividend is taxed at 15 percent. I.R.C. § 1(h)(1)(C), as amended by Pub. L. 108-27, § 301(b)(2)(A), 117 Stat. 752. The dividend is taxed at a 0 percent rate, and thus is exempt from tax, if the recipient falls below the 25 percent tax bracket. I.R.C. § 1(h)(1)(B), as amended by Pub. L. 108-27, § 301(a)(1), 117 Stat. 752.


Conclusion

Understandably, the dividend tax cut reduced the tax cost associated with corporate dividends. If an individual needs to access a closely held corporation’s earnings, there may now be an overall tax advantage to receiving a dividend instead of compensation. Because the incentives and tradeoffs are not the same in all cases, tax advisors must carefully consider the tax effects of each payout scenario. Their analysis must include whether the payout is made before or after the dividend tax cut and temporary tax rate tables expire.

The Professional Services group, led by Sam Braunstein, has been expanding the outreach of our CLE presentations, and increasing the number of people that we reach. We are pleased that we have been able to cosponsor CLE programs in various geographic areas, working with state and local bar associations to provide high-quality materials, subject matter and presenters. We have received a good deal of positive feedback for these efforts.

Our communications outreach under Vice Chair of Communications, Ellen April, has been very successful this year. In light of the housing foreclosure issues that have been in the forefront of the news, we produced an audio news release to inform affected consumers of the tax implications they may be facing. As that issue continues to develop, we will expand our outreach in that regard. During tax season, we produced a video news release and two audio news releases on tax scams and what to look out for when offers appear “too good to be true.” The audio news releases have been more successful in reaching taxpayer audiences, drawing some eight million listeners each, while the video is less well-received by broadcast networks and affiliates. Our efforts will be more focused on audio outreach in the future. I want to thank our Vice Chair of Administration, Ruddy Ramelli, for his work in securing a new primary sponsor for the Section. Thompson Tax and Accounting and Thompson West signed a three year sponsorship contract that became effective January 1, 2008. That relationship has already been successful for the Section and its membership, and we are extremely pleased that our meeting materials are now accessible and searchable from the TaxIQ link on the Section’s website. We hope that this relationship will continue for many years to come.

Finally, we missed those of you who were not able to attend the May Meeting in Washington, DC, in May. The Meeting was very successful, with more than 2300 registrants, and more than 200 representatives from various government entities participating in our many continuing legal education programs. We hope that you will be able to join us at the Joint Fall Meeting in San Francisco with the Trust & Estate division of the Real Property Trust and Estate Section. We look forward to seeing you there.

Again, thank you for the privilege of serving as your Chair this past year.