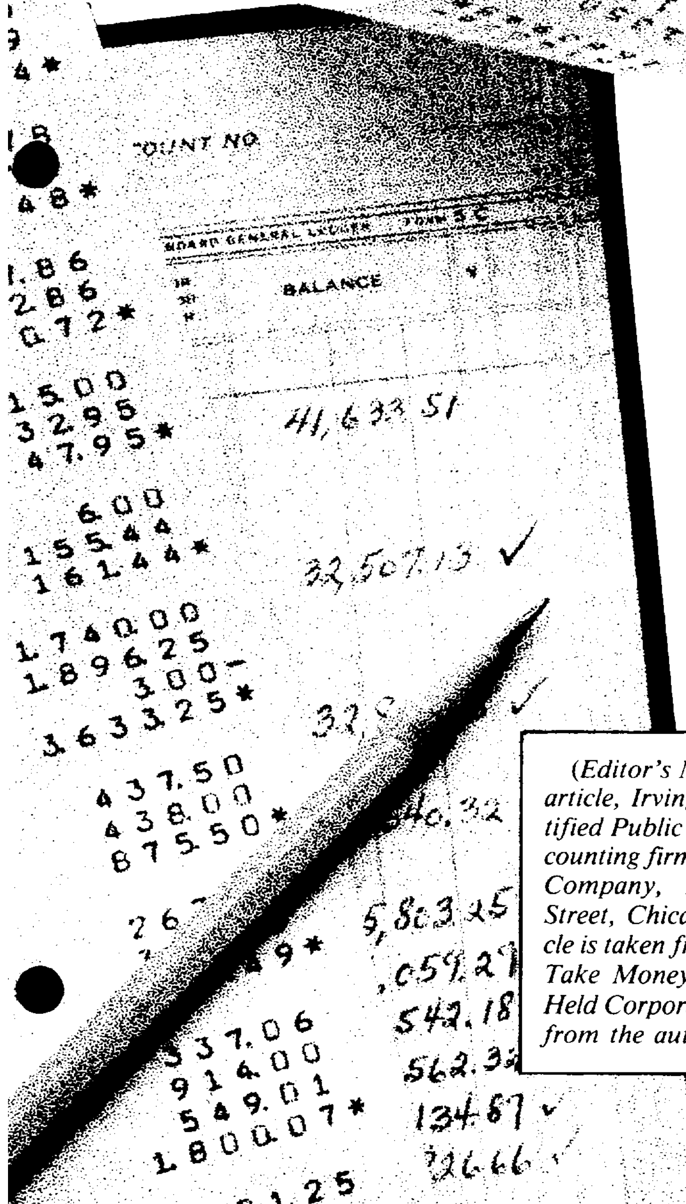
Taking The Money Out

To Get Your Reward Out of a Corporation You Must Know Answers To a Number of Questions



(Editor's Note: The author of this article, Irving L. Blackman is a Certified Public Accountant with the accounting firm of Blackman, Kallick & Company, Ltd., 180 N. LaSalle Street, Chicago, IL 60601. The article is taken from his report, "How to Take Money Out of Your Closely-Held Corporation," available for $17 from the author.)

By Irving L. Blackman, C.P.A.

Closely-held American business seems to be engaged in the worst kind of Catch-22 dilemma. If your business is successful, tax consultants advise you to incorporate to save taxes. You do. Then the same consultants caution you with a long list of "No, you can't do that."

Frustrated business owners keep asking: "Was incorporating smart in the first place? Should I stay incorporated? If so, how can I take money out of my corporation?" To understand the dilemma and minimize the tax cost you must know the answers to all of the questions.

Was Incorporation Smart?

For successful business, the simple fact of incorporation usually produces immediate tax savings. Why? The answer lies in the corporate tax rates. A corporation pays taxes as follows:

Taxable Income	Tax on Column 1	% on Excess
$25,000 or less		16%
25,000	$ 4,000	20
50,000	9,000	30
75,000	16,000	40
100,000	26,500	46

For example, if a corporation has $60,000 of taxable income, the tax would be $12,000 ($9,000 on the first $50,000 plus $3,000 on the next

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$10,000). Assume this corporation is owned 100% by Joe Success, who is personally in a solid 50% tax bracket. The $60,000 of corporate income, if Joe did business as sole-proprietorship, would have cost him $30,000 in tax. The corporation saved $18,000 ($30,000 - $12,000).

A married man filing a joint return with taxable income of just $46,000 is in a 44% tax bracket. A must exercise for every nonincorporated business is to substitute your own estimated profits and tax brackets to determine the potential annual tax savings by doing business as a corporation.

Is Staying a Corporation Smart

As long as the corporation stays profitable, capturing taxable dollars in the corporation at lower rates than the corporation owner's tax bracket usually results in overall tax savings—year after year, after year.

With the passage of time many successful closely-held business is sort of on the outside looking in. All those nice assets . . . Mine, all mine. True. But their is a price tag. What if you take part of the assets-in cash or in property? This taking would be labeled a "dividend." Dividends often are called "tax-horror-stories" because they are taxed twice. The corporation pays out after-tax dollars but cannot deduct them, and the stockholder must treat them as ordinary income-subject to up to 50% tax.

What about liquidating a corporation? Then you can get your hands on all the corporate assets. Definitely not a good tax move. All the accumulated earnings, since incorporation, are taxed to the stockholder on liquidation-subject to a capital gains tax of up to 20%. Worse yet, the low corporate tax brackets for future annual business profits are destroyed.

Keeping the corporation alive and well is almost always the best tax answer. And this brings us to the main purpose of this article.

How to Get It . . .

The balance of this article is a checklist of some of the methods that will show you how to accomplish this purpose.

Current fringe benefits stand at the head of the list when taking money out of a corporation. Why? The tax results are perfection—the corporation gets an immediate deduction while the employee gets a current economic benefit tax-free. Employer payment or reimbursement of all medical expenses of the employee and dependents, group term life insurance up to $50,000, and educational assistance programs are common examples. These benefits cannot discriminate in favor of highly paid employee-stockholders, officers or directors. Medical examinations, company-furnished meals and lodging, moving expenses, executive training, conventions, and business expense accounts for auto, travel and entertainment are great ways to award tax-free benefits to selected key people. A basic current fringe benefit package is rarely dramatic, but it is definitely the place to start.

Deferred fringe benefits are a must for accumulating large sums of money. In this area pension and profit sharing plans are at center stage. Not only does the employer get an immediate deduction but the funds accumulate in a tax-free trust. Such plans are designed to defer the benefit to be received by the employee. A new wrinkle allows you to get a current benefit. By inserting proper language in the plan documents, you can borrow any amount up to your vested interest from the trust. Interest paid to

the trust is deductible by you and tax-free to the trust. Interest paid to the trust is deductible by you and tax-free to the trust.

An IRA is a must for every owner/employer of a closely-held corporation. The maximum contribution is $2,000 per year. Make it. You have a choice: you can set up your own IRA contribution. If your wife is not already working, find a job for her at the company. A $2,000 IRA contribution to her separate IRA gives the family total of $4,000 of current tax-free income.

Interest-free loans by the corporation to shareholders are an outstanding way to take money out of a closely-held business. A taxpayer recently double-dipped his tax savings with court approval. First he made interest-free loans from his corporation. Then he used these funds to invest in tax-exempt bonds. The IRS yelled "foul." The court said the law was on the side of the taxpayer and any changes "are best left to Congress." (JACK BAKER vs. COMM.)

Compensation from the corporation for services rendered is the logical choice for receiving current benefits from the corporation. A common error is taking too much salary. For example, if your compensation is being taxed at 50% dollars and the corporation is in a 30% tax bracket or lower, each dollar you take costs you 20 cents or more in taxes than the corporation saves for the offsetting deduction. The amount of your compensation should be balanced considering your other income, your needs and tax bracket, the tax bracket of your corporation and making sure the amount taken does not exceed a reasonable compensation.

Amounts taken in excess of reasonable compensation can be attacked by the IRS and taxed as a nondeductible dividend to the corporation. Future columns will discuss how to increase your compensation without running afoul of the reasonable compensation tax disaster.

Preferred stock dividends present a safe and practical way of cutting the family tax bill. An example, is the best way to explain this tax saving plan. Assume you have four children and would like to use corporate funds to pay for their college education. Declare a preferred stock dividend,

(such dividends are tax-free) followed by a gift (you can gift up to $10,000 per year to each child without gift tax consequences) of the stock divided equally among the four children. Let's say the amount of the dividend is $40,000, or $10,000 of preferred stock to each child. Assume an 11% dividend rate, or $4,400 in total cash dividends—that would be $1,100 per year for each child. If the children have no other income, all of the cash dividends will be tax-free. Such preferred stock dividends can be used to divert income to any zero or low bracket family member.

Stock redemptions can be used to take money or property out of a corporation at capital gain rates. Consider this scenario. Assume Corporation X owns free and clear land and a building that originally cost $300,000. Its reduced tax basis, due to depreciation, is $100,000, and because of appreciation and inflation, the property is now worth $500,000. F, the founder of the corporation, owns 40% of the stock, while the other 60% is owned by members of his immediate family. F wants to retire. His 40% of the stock is worth $500,000. The corporation exchanges the real estate for F's stock. The tax consequences are delightful. Even though the corporation realized a $400,000 profit ($500,000 value less $100,000 basis), the transaction is tax-free to the corporation. F as a capital gain equal to the basis for the stock. F can now turn around and lease the real estate (the building only, but not the land) just as if he had purchased it for $500,000.

Lease vs. Purchase is another method of taking dollars out of the family controlled corporation. Instead of the corporation purchasing property needed in the operation of the corporation, the property is purchased by a family partnership. The property could be vacant land, improved real estate or personal property (like a computer, machinery or equipment). The property would be leased by the partnership to the corporation at fair rental. The members of the partnership could be either high-bracket taxpayers (like the founder of the corporation when the partnership is throwing off a loss due to depreciation) or low-bracket taxpayers (like children, grandchildren, or an aging mother or father when the partnership is throwing off profit).

A Subchapter S election, often thought of only for loss or low-profit corporations, should not be considered for the very profitable corporation. The Economic Recovery Tax Act of 1981 dropped the highest personal tax bracket from 70% to 50%. With the highest corporate rate at 46%, the 4% differential is immaterial. For corporations with an accumulated earnings problem, an outlook for continued high earnings, and no likely place to invest those earnings, a Subchapter S election can avoid the dividend tax problem and save taxes in the long run.

Finally, a warning: the above check list is not intended to be complete. Also, there are other methods available to help you take money out of your closely-held corporation. Nor does the above material for the methods covered intend to cover all the nuances, exceptions and tax traps for the unwary.

This article should be considered a starting point, together with the help of a competent professional tax advisor, for planning a strategy to take money out of your closely-held corporation. Tax planning saves dollars. Do it.