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OPTIONS FOR TAKING MONEY OUT OF A CORPORATION

With few exceptions, the overall plan is to have a successful corporation in which you can eventually enjoy the fruits of labor. Part of this enjoyment may involve taking money out of the corporation for your use. You want or need the money to live a certain lifestyle. That's one of the two main reasons for taking money out.

The second main reason for taking money out is for tax planning purposes: to reduce potential corporate tax liabilities, and/or to try to reach an "equilibrium" between the corporate tax bracket and your personal tax bracket. Obviously if the corporation is showing profits, it normally pays income taxes. By taking money out of the corporation in such ways that the corporation can deduct the payouts, the corporate tax liability is reduced. Within this context, if the corporate tax bracket is at a different level than your personal tax bracket, the most effective overall tax minimization involves planning the corporate payout amounts at a level which will make the corporate and individual tax brackets reach parity.

This tax planning technique notwithstanding, there is even another reason for taking money out of a corporation at a certain developmental level–due to a nasty provision in the IRS tax codes involving an "accumulated earnings tax/penalty." Believe it or not, the IRS can impose some stiff penalties on corporations that have an "unreasonable" accumulation of earnings. In effect, the tax codes do not encourage corporations to retain too much in profits or earnings without justifiable cause for this retention. They want them distributed.

How much is too much depends on a number of complicated factors which is not the subject of this treatise. However, corporations that begin to reach this potential problem level of accumulated profits need to find legitimate ways to reduce these profits. Incidentally, that's one reason corporations with this potential situation consider a Subchapter S structure. It's a special tax code provision which allows the net earnings from the corporation to flow directly to the shareholders and they pay the tax on it instead of the corporation; therefore, there may be no accumulated earnings trap.

So the overall goal is to find ways to take money out of a corporation with the least possible tax consequences for both the owner and the corporation. That's why there sometimes comes a time when just taking a salary isn't the most effective way to take money out. It may reduce or eliminate the corporation's tax liability, but it may then increase your personal tax liability too much.

Ironically, there even exists a situation where your corporation could be held accountable for paying "excess compensation" to you as an officer, or closely held participant. In other words, there could be significant penalties for taking too much out in compensation!

So why not just take out a big dividend instead of salary to get around this? You could. Except that most dividends–especially those to closely held participants like owners–are not deductible to the corporation, but they are taxable to the recipient. While this could relieve the potential problem of an accumulated earnings tax, it could create a serious tax liability issue for you personally, and it could create some tough cash flow problems for the corporation. It would have to pay tax on the profits that paid for the dividend distribution, but it wouldn't have the money for the tax–since it paid it out to you. That's one of the so-called double taxation issues of closely held corporations.

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Taking Money Out: Option #1-- Nondeductible By Corporation

The way that the money is taken out of a corporation largely determines whether or not the corporation can deduct this payout. As we have just seen, a dividend is a way of taking money out, but the corporation cannot deduct it. There are several other possibilities to be noted:

Loans From Corporation To You: If done properly, this is one way to take out money that is not currently taxable to you. However, nor is it deductible by the corporation. But if the corporation is not showing any significant profits to worry about tax-wise, and your personal tax bracket is high, this is a viable option to enhance your temporary cash flow needs at the personal level. You must make sure the loan meets all necessary standards of legitimacy such as: a good reason for borrowing, especially for temporary needs; a qualified loan agreement and payout schedule is adopted according to proper corporate bylaws; for loans in excess of $10,000, an appropriate interest rate should be paid.

Entertainment Expenses: If you do a significant amount of legitimate business entertaining for which the corporation pays, under the present 2000 rules it can deduct only 50% of these expenses. For people who enjoy entertaining, it is a legitimate way of taking money out of the corporation even though the corporation cannot deduct all of it on its tax return.

Constructive Dividend Payouts: These are payments the corporation makes that the IRS deems to be primarily for the benefit of a shareholder and no significant corporate business purpose can be proved adequately. It is a very inefficient way to take money out of a corporation, since it is taxable to the shareholder, and usually not deductible by the corporation. Some examples are: improper loans paid out, bargain rentals or sales of corporate property to shareholders, personal expenses of the shareholder paid by the corporation, certain types of life insurance premiums, and various related-party transactions. Although these payouts from the corporate checkbook will certainly reduce its profits, it is not necessarily a good or recommended option. In fact, if the IRS could prove it was wilfully and continually done, it could even lead to possible fraud charges.

Taking Money Out: Option #2--Deductible By Corporation

Salaries, Bonuses, Commissions: In one of the more commonly known options, you have the corporation pay you just like any other employee. Income taxes are withheld, and appropriate federal and state payroll taxes are paid. The income is taxable to you, and deductible by the corporation(mindful of the excess compensation rules). Within reason it also can be used as a good tax rate equalization technique by using year end bonus or commission payouts. If you know the corporation will have too high of a profit, pay yourself a nice bonus.

Directors' Fees: You may be able to pay yourself or other family members for directors' fees as board members of the corporation. This is taxable to the recipient and deductible by the corporation.

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Rental Income: If you structure it properly, you may be able to charge the corporation rent if it is using any of your property for qualified business purposes: storage, inventory, office space, etc. This may give you a partial tax sheltering since you may then be able to offset this income in part with depreciation deductions, utility, insurance, repairs and maintenance costs associated with the property. The corporation gets to deduct the rental payment and you get money out of the corporation that is not subject to social security, medicare tax, and state payroll tax. This can save upwards of 15.3% in payroll-related taxes alone.

Family Members On Payroll: The corporation pays other members of your family besides you for services rendered. The corporation takes a deduction, and the family member in question reports the income. This may have personal income tax advantages if the family member in question is in a much lower tax bracket than you are.

Travel Expense: If you can coordinate business purpose travel with personal enjoyment use in an acceptable way, this is a good option to get money out that is deductible to the corporation but non-taxable to you. Could a business convention or trade show be attended in an area you would love to visit? Could a legitimate board of directors' meeting be held in a vacation-like setting?

Reimbursements For Use Of Home: Under certain circumstances, a corporation can require an employee to maintain an office in the home and reimburse the employee for the costs. These costs could include the business-use portion of such expenses as utilities, maintenance, insurance, taxes, repairs, and depreciation on the building. This is a possible way for you to get a significant amount of tax-sheltered income out of the business.

Use Of Vehicle Reimbursement: If planned correctly, a significant portion of your vehicle expenses can be reimbursed by the corporation for business use. Especially if you are running the business out of your home, the possibility may even exist that the entire cost of at least one of your vehicles could be written off. The corporation gets a deduction for transportation expense, and it is not taxable to you.

Lease Various Business Assets To Corporation: If you or a member of your family does a proper lease arrangement for various assets (such as computer equipment, furniture, tools, etc.), the corporation can deduct these lease payments. While these payments are taxable to the recipient, some possible offsetting depreciation and operating deductions may shelter a portion–or all–of the income leading to a tax advantaged arrangement.

Set Up Various Employee Benefit Plans: If it can be handled under IRS qualifying standards, there are a number of fringe benefits you could realize–tax free, or tax reduced–and the corporation could deduct the cost of providing them. Life insurance, medical insurance, medical reimbursements, educational costs, cafeteria plans, flexible spending accounts, retirement plans, and parking fee reimbursements to name a few. Note that these are not monies coming out of the corporation so much as a direct payment plan, but the results are essentially the same.

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Conclusion

The most effective, efficient, and tax-saving ways of taking money out of a corporation can sometimes involve serious planning and foresight. The more current and future knowledge you have about such issues as the corporate vs personal tax brackets, cash flow, budgetary needs, income and expenses, and fringe benefits you want for you and your employees, the better the choice of options becomes.

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