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Plan Now or Pay Later

Everyone can remember a time in life when he or she knew it was a great time to act, hesitated, and in the end lost an opportunity. Today we are faced with the same problem. Luckily, it is not too late to act.

Currently, tax rates on dividends and long-term capital gains are set at 15 percent, as a result of the Jobs and Growth Tax Relief Reconciliation Act of 2003. However, beginning on Jan. 1, 2011, the federal income tax rate on dividends will increase from 15 percent to as high as 39.6 percent, while the federal tax rate on long-term capital gains will rise from 15 percent to 20 percent.

Also, the Patient Protection and Affordable Care Act of 2010 will increase tax rates in 2013 with the addition of a 3.8 percent Medicare tax on not just earnings, but on all income for certain persons in higher tax brackets.

Below are some strategies to consider before Jan. 1, 2011, to help your financial organization and shareholders mitigate some of the negative effects of the increasing federal tax rates.

Dividends. Pay dividends to your shareholders in 2010 so that your shareholders can take advantage of this year's lower tax rates. This can be accomplished by declaring a "special dividend" at the end of 2010 or accelerating to 2010 a regular dividend that otherwise would be paid in 2011. The effective tax rate on dividends in 2011 could be more than 42 percent (and more than 65 percent in 2013 when including the Medicare tax).

Additionally, a dividend may help an organization taxed as a C corp avoid the accumulated earnings tax, which is also scheduled to rise in 2011. The AET acts as a penalty on a corporation for excessively accumulating earnings instead of making dividend distributions to shareholders (a strategy by which the shareholders avoid taxes on distributions). The AET rate is the same rate at which dividends are taxed. Therefore, if your organization has accumulated earnings, it is beneficial to pay dividends at 2010's lower rates, rather than be assessed with the AET in future years when the dividend and AET rates will be higher. By paying out the accumulated earnings, you will be able to rebuild them in future years. Note: Make sure that a reduction in accumulated earnings does not violate any debt covenants or regulatory restrictions.

Redemptions. Redeem stock from shareholders in 2010. Depending on the circumstances, this form of transaction may be taxed to the shareholder as capital gains or as a dividend (or both). Redemption may be the appropriate course of action if the financial organization cannot pay a dividend. For 2010, there is no difference in the federal tax effect for the two outcomes. Regulatory approval is often required for redemption.

Redemptions can be used to allow a financial organization to lower the number of its shareholders to (a) avoid registering as a public company; or (b) allow a financial organization to elect or maintain S corp tax status (a financial organization must have less than 100 shareholders to be eligible for such status). Redemptions also facilitate the liquidation of shareholders' stock if there is no readily available market, while at the same time increasing the per share value of the outstanding capital stock for the remaining shareholders.

Deferrals. To the extent possible, consider deferring capital losses and deductions to 2011 and beyond to offset any anticipated capital gains on ordinary income. Simply put, would the capital losses and deductions be more valuable to you to offset capital gains and ordinary income that are taxed at the lower 2010 tax rates or at the 2011 rates, which will be higher? If you have significant capital losses for 2010, any loss in excess of capital gains can be carried forward to be used next year. If you will have significant capital gains in 2010, then this may not be an appropriate strategy.

Estate planning. Shareholders should consider their personal estate planning needs. Will stock, for instance, be transferred from one generation to the next by gift or sale?

These tax law changes are only one factor to keep in mind when considering potential transactions. Every organization should review its own individual goals, financial position and relevant regulatory factors in determining whether to proceed with any of the suggestions discussed above. Also, consult with your financial and legal advisers. BN