Shannon & Associates LLP
Certified Public Accountants
Management Consultants

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Dear Clients and Friends,

Business owners often grow their business by continually reinvesting earnings and profits. This is a good strategy, but eventually most business owners will want to tap into these earnings. The problem is that withdrawing cash from a corporation can be very tax inefficient. The purpose of this letter is to alert you to tax planning opportunities that exist this year that will allow you to tap into the hard-earned cash of your business at historically low tax costs.

Normally, dividend treatment is something to avoid because of the double taxation issue. In effect, dividends are subject to double taxation. Your corporation pays income taxes on the earnings that generate the dividends, then you have to pay income taxes too when the earnings are paid out to you. This harsh effect has been softened somewhat for the last several years because the maximum dividend tax rate was only 15%. However, in 2013, barring any tax legislation, this favorable maximum rate is scheduled to skyrocket. The actual tax rate you will pay on dividends will depend on your marginal ordinary tax rate. However, for taxpayers in the top ordinary tax rate bracket, it looks like the federal tax rate could be as high as 43.4% after 2012.

If your corporation has built up substantial earnings and profits over the years, sometime before the end of 2012 is an ideal time to consider paying some dividends. Although, double taxation is assured, a 15% tax rate may be quite manageable. In addition to getting cash into your hands at historically low tax rates, paying dividends this year may have additional benefits for your corporation:

- *Reduce Future Exposure to Accumulated Earnings Penalty Tax.* A profitable corporation becomes exposed to the accumulated earnings penalty tax when it accumulates earnings in excess of reasonable business needs and does not pay dividends. Right now, the accumulated earnings tax rate is only 15%. Absent a law change, after 2012, the accumulated earnings tax rate will return to the maximum individual federal rate on ordinary income – 39.6% for 2013. Therefore, now is a great time to pay out dividends and reduce your corporation's exposure to the penalty tax.
- *Better Tax Treatment for Distributions in Future Years.* To the extent 2012 cash distributions reduce the corporation's earnings and profits, there's a greater likelihood that distributions in future years will be treated as tax-free returns of compensation paid to business owners (which is deductible by the corporation) as disguised dividends (which aren't deductible). In other words, future compensation amounts will be easier to defend as reasonable if at least some dividends have been paid in the past.

As you can see, the current low federal tax rates on dividends make the idea of taking corporate distributions a better idea than at any time in recent memory. With careful planning, we can help you determine whether you would benefit from having your corporation make dividend distributions this year. Please give us a call if you have any questions or want more information.

Sincerely,

Shannon & Associates LLP

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