

Planning Strategies Under the Proposed Bush Tax Plan

President Bush recently announced his economic stimulus plan. The centerpiece of his proposal is a \$674 billion tax cut; \$374 billion of which comes over 10 years from the exclusion of dividends paid by a corporation from the income of shareholders. The stated purpose of the exclusion of dividends from income is that dividends are subject to a greater level of tax because corporate income is taxed once at 34% at the corporate level and again when shareholders report their dividend income on their personal returns. Most practitioners consider the “double tax” as unfair to business owners who chose to incorporate their business, rather than using another form of business.

While most of the commentary has focused on how this will affect shareholders of large, publicly traded corporations, the benefit to the shareholder/employees of small, closely held corporations will be even more dramatic. If this proposal becomes law, it will be a fundamental change in our tax law and result in huge benefits and tax breaks for closely held business owners. The main benefit will be that business owners should no longer have to pay themselves generous salaries to reduce the taxable income of the corporation to mitigate high cost of the double tax. Since business owners will dramatically reduce their salaries, they will also escape local, state and federal income withholding taxes, social security taxes, medicare taxes and unemployment taxes on a significant portion of their income. Secondly, business owners who previously found that they could not utilize all of their personal itemized deductions because their salaries were too high, thereby causing their deductions to be “phased out,” should be able to engineer their income to take full advantage of their itemized deductions. Finally, this change should allow business owners to better utilize the low 15% corporate tax rate to reduce their overall tax rate.

Given these incredible benefits, business owners who currently operate their businesses as LLCs taxed as partnerships or as sole proprietors should explore switching to be taxed as a corporation. Even though there would be some trade-offs that result from such an election, this could allow business owners to pay themselves in dividends and be excused from nearly all of their income and employment tax burdens. The IRS and the states will need to respond to this abuse by passing complex regulations and new laws that will prevent the use of corporations as tax shelters.

Whether the estimated cost of the Bush Plan accounts for the fundamental change in economic behavior that will result if the dividend exclusion proposal becomes law is doubtful; and whether it is sound fiscal and tax policy is debatable. However, it is certain that this change could be the most significant change in tax law in our lifetime.

Geoffrey P. Scott
805 Olenhurst Court
Columbus, Ohio 43235
(614) 436-8521