Zachary Scott
INVESTMENT BANKERS

IN$IGHT
PERSPECTIVES ON THE CAPITAL MARKETS
REPRINT
SUMMER 2012

A Dividend Strategy for C-Corporations

Better rethink periodic dividends to shareholders before tax rates go up in 2013.

by Frank S. Buhler

In our Spring 2012 issue of IN$IGHT, we described how tax rate increases currently scheduled to take effect on January 1, 2013 will affect business owners. For owners of C-Corporations, the dramatic rise in tax rates on qualified dividends will make periodic dividends an extremely inefficient way to transfer liquidity to shareholders.

Owners have an immediate, one-time opportunity prior to the end of 2012 to extract liquidity in a more tax efficient manner than having to sell an interest in the business by borrowing to pre-fund future dividends.

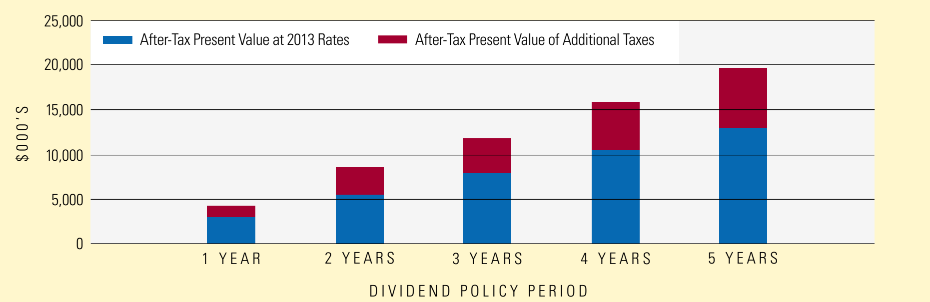
BACKGROUND

C-corporations currently pay taxes at the corporate level up to a maximum rate of 35%.

Locking in the current tax framework can be accomplished by accelerating future dividends into 2012 by borrowing to fund qualified dividends prior to the tax change. The significant difference in qualified dividend rates between 2012 and years thereafter make a special dividend in 2012 a rational economic decision, even after taking into account the cost of borrowing.

Any dividends paid to shareholders then are taxed at the shareholder level as a qualified dividend at rates of up to 15%. The combination of these two taxes (35% tax on corporate profits plus the 15% tax on the after-tax earnings distributed to shareholders) represents the "double taxation" of corporate profits, which currently tops out at 44.75%. Shareholders receive 55.25% of each dollar of pre-tax profits. The tax rate on qualified dividends paid by shareholders is scheduled to increase in 2013 from the current maximum rate of 15% to a top rate of 43.4%, resulting in a comparable double tax rate of 63.2% on profits, leaving only 36.8% of pre-tax profits for the shareholder.

Present Value of Future Dividends and Taxes at 2013 Rates



To quantify the effect of these tax rate changes on dividend policy, the adjacent exhibit shows the difference in the after-tax present value of an annual $5 million dividend for various future periods under the qualified dividend tax rate structures for both 2012 and 2013. The chart illustrates that as the future period of dividends and higher taxes lengthens, the amount of new tax burden rises.

ALTERNATIVE

Locking in the current tax framework can be accomplished by accelerating future dividends into 2012 by borrowing to fund qualified dividends prior to the tax change. The significant difference in qualified dividend rates between 2012 and years thereafter make a special dividend in 2012 a rational economic decision, even after taking into account the cost of borrowing.

For illustrative purposes, let's assume that a C-corporation currently has a policy of paying annual dividends of $5 million. To hedge against the future tax premium, the company could accelerate five future years of dividends ($25 million) to 2012 while retaining a neutral cash flow impact on the corporation.

After taking into account the cost of borrowing at current senior debt rates, the company could pay a $22.9 million dividend to shareholders in 2012. Taxed at a rate of 15%, the shareholders would receive after-tax proceeds of $19.5 million, which represents a

Interestingly, borrowing costs do not drive this economic decision. The borrowing rate would have to exceed 40% per annum to reach the point of indifference between accelerating dividends into 2012 or receiving them over time subject to the higher 2013 rates.

savings of $6.5 million relative to maintaining the annual dividend policy and paying higher future tax rates.

Interestingly, borrowing costs do not drive this economic decision. The borrowing rate would have to exceed 40% per annum to reach the point of indifference between accelerating dividends into 2012 or receiving them over time subject to the higher 2013 rates.

BALANCE SHEET LEVERAGE

Even with the current strong credit market, some corporations might not wish to leverage the company's balance sheet to provide shareholder liquidity, or do not have

(continued p. 2)

sufficient borrowing capacity to fund the advanced dividend. Owners can still accomplish this tax rate hedge by lending the after-tax dividend proceeds back to the company in the form of a shareholder loan. This would lock in the 2012 tax rates for future dividends, while providing the company with flexible repayment terms. The net result to the company would be increased borrowings in an amount equal to the taxes on the accelerated dividend (15%).

ACCELERATE DIVIDENDS OR SELL INTERESTS?

Certainly, tax laws do change and can change again, and none of us can predict what Congress may do to future tax rates. However, as it stands now, scheduled tax rate increases will create an economic disincentive to return capital to shareholders in the form of dividends, instead favoring selective disproportionate share redemptions, an outright sale of the business, or retention of cash inside the corporation. Owners of C-corporations that anticipate making dividend payments to shareholders over the next few years should seriously consider the alternative of accelerating dividends into 2012. ❖

Owners of C-corporations that anticipate making dividend payments to shareholders over the next few years should seriously consider the alternative of accelerating dividends into 2012.

Zachary Scott
INVESTMENT BANKERS

1200 Fifth Avenue, Suite 1500
Seattle, Washington 98101

www.ZacharyScott.com

ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

Mark D. Working
206.224.7382
mworking@zacharyscott.com

William S. Hanneman
206.224.7381
bhanneman@zacharyscott.com

Frank S. Buhler
206.224.7383
fbuhler@zacharyscott.com

Michael T. Newsome
206.224.7387
mnewsome@zacharyscott.com

Ray D. Rezab
206.224.7386
rrezab@zacharyscott.com

Doug Cooper
206.224.7388
dcooper@zacharyscott.com

Jay Schembs
206.838.5524
jschembs@zacharyscott.com

Michael J. Black
206.838.5526
mblack@zacharyscott.com