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Taxation of Owner's Distributions
(Course #6070C/QAS6070C)

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Taxation of Owner's Distributions

This chapter focuses on the manner in which profits are distributed to the owners of various entities – be they partners in a general partnership or shareholders in a classic C corporation – and the manner in which they are taxed.

I. Single-Owner Entities

When an individual elects to go into business for himself, there are three choices available when selecting a type of entity: (1) the classic sole proprietorship; (2) a corporation; or (3) a limited liability company. The tax treatment of distributions will be different with each form, as shown in Table 1, below:

Table 1 Taxation of Single-Member Entities

ENTITY TYPE	TAX EFFECT OF DISTRIBUTION
Sole Proprietor	All profits and losses flow directly to the owner and are taxed at his/her individual rate
Corporation	In a traditional C corporation, profits are taxed at the corporate level; dividends paid to shareholders are then taxed again at the rate of the individual rate of the shareholder
Limited Liability Company	Member can elect to have distributions taxed as a corporation or flow through to the owner and have the entity "disregarded" for federal tax purposes

The limited liability company is often the best option for the single-owner in that it provides the limited liability offered by a corporation, as well as the option to avoid the double-taxation of a corporation on distributions. Other considerations discussed in this course obviously also affect the ultimate choice of entity.

II. Partnerships

A. DISTRIBUTIONS: ALLOCATING PROFITS AND LOSSES

The general default rule of most states, as provided in the Uniform Partnership Act (UPA) § 401, is that each partner is entitled to an equal share of the profits and is likewise responsible for an equal share of the losses. As with most default rules, of course, the partners are free to agree to a different arrangement in their written partnership agreement.

U.P.A. Section 401. *Partner's Rights and Duties*

(a) Each partner is deemed to have an account that is:
(1) credited with an amount equal to the money plus the value of any other property, net of the amount of any liabilities, the partner contributes to the partnership and the partner's share of the partnership profits; and
(2) charged with an amount equal to the money plus the value of any other property, net of the amount of any liabilities, distributed by the partnership to the partner and the partner's share of the partnership losses.
(b) Each partner is entitled to an equal share of the partnership profits and is chargeable with a share of the partnership losses in proportion to the partner's share of the profits.
(c) A partnership shall reimburse a partner for payments made and indemnify a partner for liabilities incurred by the partner in the ordinary course of the business of the partnership or for the preservation of its business or property.
(d) A partnership shall reimburse a partner for an advance to the partnership beyond the amount of capital the partner agreed to contribute.
(e) A payment or advance made by a partner which gives rise to a partnership obligation under subsection (c) or (d) constitutes a loan to the partnership which accrues interest from the date of the payment or advance.

Subsection (a) provides that each partner is deemed to have an account that is credited with the partner's contributions and share of the partnership profits and charged with distributions to the partner and the partner's share of partnership losses. In the absence of another system of partnership accounts, these rules establish a basic system of accounts for the partnership.

Under the default rule, partners share profits per capita and not in proportion to capital contribution as do corporate shareholders or partners in limited partnerships. If partners agree to share profits other than equally, losses will be shared similarly to profits, absent agreement to do otherwise. Of course, by agreement, they may share losses on a different basis from profits. The default rules apply even where one or more of the partners contribute no capital.

The Revised Uniform Limited Partnership Act (RULPA) has no specific provision allocating profits and losses among the partners. Instead, the Act directly apportions the right to receive distributions. Nearly all limited partnerships will choose to allocate profits and losses in order to comply with applicable tax, accounting and other regulatory requirements. Those requirements, rather than this Act, are the proper source of guidance for that profit and loss allocation.

Section 503. *Sharing Of Distributions*

A distribution by a limited partnership must be shared among the partners on the basis of the value, as stated in the required records when the limited partnership decides to make the distribution, of the contributions the limited partnership has received from each partner.

B. INTERIM DISTRIBUTIONS

Under RULPA § 504, a partner does not have a right to any distribution before the dissolution and winding up of the limited partnership unless the limited partnership decides to make an interim distribution. Likewise, RULPA § 505 provides that a partner does not have a general right to receive a distribution on account of dissociation. However, RULPA Sections 603 and 604 permitted a limited partner to withdraw on six months notice and receive the fair value of the limited partnership interest, unless the partnership agreement provided the limited partner with some exit right or stated a definite duration for the limited partnership.

C. DISTRIBUTIONS IN-KIND

Both the UPA and the RULPA provide that a partner does not have the right to receive *and* may not be required to accept in-kind distributions. This rule is complemented in the UPA by a provision which provides that, in winding up the partnership business upon dissolution, any surplus after the payment of partnership obligations must be applied to pay in cash the net amount distributable to each partner.

D. TRANSFER OF DISTRIBUTIONAL RIGHTS

While both the UPA and the RULPA prohibit a partner from transferring his partnership interest without the consent of the other partners, a partner is almost always free to transfer his or her right to receive distributions.

For example, UPA § 507 provides: “When a partner or transferee becomes entitled to receive a distribution, the partner or transferee has the status of, and is entitled to all remedies available to, a creditor of the limited partnership with respect to the distribution. However, the limited partnership's obligation to make a distribution is subject to offset for any amount owed to the limited partnership by the partner or dissociated partner on whose account the distribution is made.”

E. LIMITATIONS ON DISTRIBUTIONS

Even when authorized by default provisions or by a specific provision of a partnership agreement, there are circumstances in which making a distribution is wrongful. RULPA § 508 is illustrative of a common state law treatment of this issue:

Section 508. *Limitations On Distribution*

(a) A limited partnership may not make a distribution in violation of the partnership agreement.

(b) A limited partnership may not make a distribution if after the distribution:
(1) the limited partnership would not be able to pay its debts as they become due in the ordinary course of the limited partnership's activities; or

(2) the limited partnership's total assets would be less than the sum of its total liabilities plus the amount that would be needed, if the limited partnership were to be dissolved, wound up, and terminated at the time of the distribution, to satisfy the preferential rights upon dissolution, winding up, and termination of partners whose preferential rights are superior to those of persons receiving the distribution.

(c) A limited partnership may base a determination that a distribution is not prohibited under subsection (b) on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances or on a fair valuation or other method that is reasonable in the circumstances.

(d) Except as otherwise provided in subsection (g), the effect of a distribution under subsection (b) is measured:
(1) in the case of distribution by purchase, redemption, or other acquisition of a transferable interest in the limited partnership, as of the date money or other property is transferred or debt incurred by the limited partnership; and
(2) in all other cases, as of the date:
(A) the distribution is authorized, if the payment occurs within120 days after that date; or
(B) the payment is made, if payment occurs more than120 days after the distribution is authorized.

(e) A limited partnership's indebtedness to a partner incurred by reason of a distribution made in accordance with this section is at parity with the limited partnership's indebtedness to its general, unsecured creditors.

(f) A limited partnership's indebtedness, including indebtedness issued in connection with or as part of a distribution, is not considered a liability for purposes of subsection (b) if the terms of the indebtedness provide that payment of principal and interest are made only to the extent that a distribution could then be made to partners under this section.

(g) If indebtedness is issued as a distribution, each payment of principal or interest on the indebtedness is treated as a distribution, the effect of which is measured on the date the payment is made.

RULPA § 509 imposes liability on partners for making improper distributions under certain circumstances:

Section 509. *Liability for Improper Distributions*

(a) A general partner that consents to a distribution made in violation of Section 508 is personally liable to the limited partnership for the amount of the distribution which exceeds the amount that could have been distributed without the violation if it is established that in consenting to the distribution the general partner failed to comply with Section 408.

(b) A partner or transferee that received a distribution knowing that the distribution to that partner or transferee was made in violation of Section 508 is personally liable to the limited partnership but only to the extent that the distribution received by the partner or transferee exceeded the amount that could have been properly paid under Section 508.

(c) A general partner against which an action is commenced under subsection (a) may:
(1) implead in the action any other person that is liable under subsection (a) and compel contribution from the person; and
(2) implead in the action any person that received a distribution in violation of subsection (b) and compel contribution from the person in the amount the person received in violation of subsection (b).

(d) An action under this section is barred if it is not commenced within two years after the distribution.

A limited partnership's failure to meet the standard of § 508(c) cannot by itself cause a general partner to be liable under § 509(a). *Both* of the following would have to occur before a failure to satisfy § 508(c) could result in personal liability for a general partner under § 509(a):

- The limited partnership "base[s] a determination that a distribution is not prohibited . . . on financial statements prepared on the basis of accounting practices and principles that are [not] reasonable in the circumstances or on a [not] fair valuation or other method that is [not] reasonable in the circumstances" [§ 508(c)]; and

- The general partner's decision to rely on the improper methodology in consenting to the distribution constitutes "grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law" [§ 408(c)] or breaches some other duty under § 408.

To serve the protective purpose of §§ 508 and 509, in this subsection "consent" must be understood as encompassing any form of approval, assent or acquiescence, whether formal or informal, express or tacit.

III. Taxation of Partnership Distributions

A. DEFINING "DISTRIBUTION"

The various types of partnerships discussed earlier in this course generally do not affect taxation issues. This section will therefore deal with partnerships as a whole. For purposes of taxation, partnership distributions include the following:

- A withdrawal by a partner in anticipation of the current year's earnings;

- A distribution of the current year's or prior years' earnings not needed for working capital;

- A complete or partial liquidation of a partner's interest; and

- A distribution to all partners in a complete liquidation of the partnership.

A partnership distribution is not taken into account in determining the partner's distributive share of partnership income or loss. If any gain or loss from the distribution is recognized by the partner, it must be reported on his or her return for the tax year in which the distribution is received. Money or property withdrawn by a partner in

anticipation of the current year's earnings is treated as a distribution received on the last day of the partnership's tax year.

A partner's adjusted basis in his or her partnership interest is decreased (but not below zero) by the money and adjusted basis of property distributed to the partner. A partnership generally does not recognize any gain or loss because of distributions it makes to partners. The partnership may be able to elect to adjust the basis of its undistributed property.

B. DISTRIBUTIONS TREATED AS SALE OR EXCHANGE

When a partnership distributes the following items, the distribution may be treated as a sale or exchange of property rather than a distribution:

- Unrealized receivables or substantially appreciated inventory items distributed in exchange for any part of the partner's interest in other partnership property, including money; or

- Other property (including money) distributed in exchange for any part of a partner's interest in unrealized receivables or substantially appreciated inventory items.

This treatment does not apply to the following distributions:

- A distribution of property to the partner who contributed the property to the partnership; and

- Payments made to a retiring partner or successor in interest of a deceased partner that are the partner's distributive share of partnership income or guaranteed payments.

C. SUBSTANTIALLY APPRECIATED INVENTORY

Inventory items of the partnership are considered to have appreciated substantially in value if, at the time of the distribution, their total fair market value is more than 120% of the partnership's adjusted basis for the property. However, if a principal purpose for acquiring inventory property is to avoid ordinary income treatment by reducing the appreciation to less than 120%, that property is excluded.

D. PARTNER’S GAIN OR LOSS

A partner generally recognizes gain on a partnership distribution only to the extent any money (and marketable securities treated as money) included in the distribution exceeds the adjusted basis of the partner's interest in the partnership. Any gain recognized is generally treated as capital gain from the sale of the partnership interest on the date of the distribution. If partnership property (other than marketable securities treated as money) is distributed to a partner, he or she generally does not recognize any gain until the sale or other disposition of the property.

Example.

The adjusted basis of Jo's partnership interest is $14,000. She receives a distribution of $8,000 cash and land that has an adjusted basis of $2,000 and a fair market value of $3,000. Because the cash received does not exceed the basis of her partnership interest, Jo does not recognize any gain on the distribution. Any gain on the land will be recognized when she sells or otherwise disposes of it. The distribution decreases the adjusted basis of Jo's partnership interest to $4,000 [$14,000 - ($8,000 + $2,000)].

1. <u>Marketable Securities Treated as Money</u>

Generally, a marketable security distributed to a partner is treated as money in determining whether gain is recognized on the distribution. This treatment, however, does not generally apply if that partner contributed the security to the partnership or an investment partnership made the distribution to an eligible partner.

The amount treated as money is the security's fair market value when distributed, reduced (but not below zero) by the excess (if any) of:

- The partner's distributive share of the gain that would be recognized had the partnership sold all its marketable securities at their fair market value immediately before the transaction resulting in the distribution, over

- The partner's distributive share of the gain that would be recognized had the partnership sold all such securities it still held after the distribution at the fair market value as described immediately above.

More information on this issue, including the definition of marketable securities, can be found by reviewing § 731(c) of the Internal Revenue Code.

2. <u>Loss on Distribution</u>

Subject to a few exceptions, a partner does not recognize loss on a partnership distribution unless all of the following requirements are met:

- The adjusted basis of the partner's interest in the partnership exceeds the distribution;

- The partner's entire interest in the partnership is liquidated; and

- The distribution is in money, unrealized receivables, or inventory items.

3. <u>Distribution of Partner's Debt</u>

If a partnership acquires a partner's debt and extinguishes the debt by distributing it to the partner, the partner will recognize capital gain or loss to the extent the fair market value of the debt differs from the basis of the debt.

The partner is treated as having satisfied the debt for its fair market value. If the issue price (adjusted for any premium or discount) of the debt exceeds its fair market value when distributed, the partner may have to include the excess amount in income as canceled debt. Similarly, a deduction may be available to a corporate partner if the fair market value of the debt at the time of distribution exceeds its adjusted issue price.

4. Net Pre-Contribution Gain

A partner generally must recognize gain on the distribution of property (other than money) if the partner contributed appreciated property to the partnership during the 7-year period before the distribution. A 5-year period applies to property contributed before June 9, 1997, or under a written binding contract:

- That was in effect on June 8, 1997, and at all times thereafter before the contribution, and
- That provides for the contribution of a fixed amount of property.

The gain recognized is the lesser of the following amounts:

- The excess of:
  - The fair market value of the property received in the distribution, over
  - The adjusted basis of the partner's interest in the partnership immediately before the distribution, reduced (but not below zero) by any money received in the distribution.
- The "net pre-contribution gain" of the partner. This is the net gain the partner would recognize if all the property contributed by the partner within seven years (five years for property contributed before June 9, 1997) of the distribution, and held by the partnership immediately before the distribution, were distributed to another partner, other than a partner who owns more than 50% of the partnership.

The character of the gain is determined by reference to the character of the net pre-contribution gain. This gain is in addition to any gain the partner must recognize if the money distributed is more than his or her basis in the partnership. For these rules, the term "money" includes marketable securities treated as money.

5. Effect on Basis

The adjusted basis of the partner's interest in the partnership is increased by any net pre-contribution gain recognized by the partner. Other than for purposes of determining the gain, the increase is treated as occurring immediately before the distribution.

The partnership must adjust its basis in any property the partner contributed within seven years (five years for property contributed before June 9, 1997) of the distribution to reflect any gain that partner recognizes under this rule.

Any part of a distribution that is property the partner previously contributed to the partnership is not taken into account in determining the amount of the excess distribution or the partner's net pre-contribution gain. For this purpose, the partner's previously contributed property does not include a contributed interest in an entity to the extent its value is due to property contributed to the entity after the interest was contributed to the partnership.

Recognition of gain under this rule also does not apply to a distribution of unrealized receivables or substantially appreciated inventory items if the distribution is treated as a sale or exchange, as discussed earlier.

6. Partner's Basis for Distributed Property

Unless there is a complete liquidation of a partner's interest, the basis of property (other than money) distributed to the partner by a partnership is its adjusted basis to the partnership immediately before the distribution. However, the basis of the property to the partner cannot be more than the adjusted basis of his or her interest in the partnership reduced by any money received in the same transaction.

Example 1.

The adjusted basis of Beth's partnership interest is $30,000. She receives a distribution of property that has an adjusted basis of $20,000 to the partnership and $4,000 in cash. Her basis for the property is $20,000.

Example 2.

The adjusted basis of Mike's partnership interest is $10,000. He receives a distribution of $4,000 cash and property that has an adjusted basis to the partnership of $8,000. His basis for the distributed property is limited to $6,000 ($10,000 - $4,000, the cash he receives).

a. Complete liquidation of partner's interest

The basis of property received in complete liquidation of a partner's interest is the adjusted basis of the partner's interest in the partnership reduced by any money distributed to the partner in the same transaction.

b. Partner's holding period

A partner's holding period for property distributed to the partner includes the period the property was held by the partnership. If the property was contributed to the partnership by a partner, then the period it was held by that partner is also included.

c. Basis divided among properties

If the basis of property received is the adjusted basis of the partner's interest in the partnership (reduced by money received in the same transaction), it must be divided among the properties distributed to the partner. For property distributed after August 5, 1997, allocate the basis using the following rules.

- Allocate the basis first to unrealized receivables and inventory items included in the distribution by assigning a basis to each item equal to the partnership's adjusted basis in the item immediately before the distribution. If the total of these assigned bases exceeds the allocable basis, decrease the assigned bases by the amount of the excess.

- Allocate any remaining basis to properties other than unrealized receivables and inventory items by assigning a basis to each property equal to the partnership's adjusted basis in the property immediately before the distribution. If the allocable basis exceeds the total of these assigned bases, increase the assigned bases by the amount of the excess. If the total of these assigned bases exceeds the allocable basis, decrease the assigned bases by the amount of the excess.

d. Allocating a basis increase

Allocate any basis increase required in rule (2), above, first to properties with unrealized appreciation to the extent of the unrealized appreciation. (If the basis increase is less than the total unrealized appreciation, allocate it among those properties in proportion to their respective amounts of unrealized appreciation.) Allocate any remaining basis increase among all the properties in proportion to their respective fair market values.

Example.

Julie's basis in her partnership interest is $55,000. In a distribution in liquidation of her entire interest, she receives properties A and B, neither of which is inventory or unrealized receivables. Property A has an adjusted basis to the partnership of $5,000 and a fair market value of $40,000. Property B has an adjusted basis to the partnership of $10,000 and a fair market value of $10,000.

To figure her basis in each property, Julie first assigns bases of $5,000 to property A and $10,000 to property B (their adjusted bases to the partnership). This leaves a $40,000 basis increase (the $55,000 allocable basis minus the $15,000 total of the assigned bases). She first allocates $35,000 to property A (its unrealized appreciation). The remaining $5,000 is allocated between the properties based on their fair market values. $4,000 ($40,000/$50,000) is allocated to property A and $1,000 ($10,000/$50,000) is allocated to property B. Julie's basis in property A is $44,000 ($5,000 + $35,000 + $4,000) and her basis in property B is $11,000 ($10,000 + $1,000).

e. Allocating a basis decrease

Use the following rules to allocate any basis decrease required in rule (1) or rule (2), earlier.

- Allocate the basis decrease first to items with unrealized depreciation to the extent of the unrealized depreciation. (If the basis decrease is less than the total unrealized depreciation, allocate it among those items in proportion to their respective amounts of unrealized depreciation.)

- Allocate any remaining basis decrease among all the items in proportion to their respective assigned basis amounts (as decreased in (1)).

  Example.

  Tom's basis in his partnership interest is $20,000. In a distribution in liquidation of his entire interest, he receives properties C and D, neither of which is inventory or unrealized receivables. Property C has an adjusted basis to the partnership of $15,000 and a fair market value of $15,000. Property D has an adjusted basis to the partnership of $15,000 and a fair market value of $5,000.

  To figure his basis in each property, Tom first assigns bases of $15,000 to property C and $15,000 to property D (their adjusted bases to the partnership). This leaves a $10,000 basis decrease (the $30,000 total of the assigned bases minus the $20,000 allocable basis). He allocates the entire $10,000 to property D (its unrealized depreciation). Tom's basis in property C is $15,000 and his basis in property D is $5,000 ($15,000 - $10,000).

f. Distributions before August 6, 1997

For property distributed before August 6, 1997, allocate the basis using the following rules:

- Allocate the basis first to unrealized receivables and inventory items included in the distribution to the extent of the partnership's adjusted basis in those items. If the partnership's adjusted basis in those items exceeded the allocable basis, allocate the basis among the items in proportion to their adjusted bases to the partnership; and

- Allocate any remaining basis to other distributed properties in proportion to their adjusted bases to the partnership.

g. Partner's interest more than partnership basis

If the basis of a partner's interest to be divided in a complete liquidation of the partner's interest is more than the partnership's adjusted basis for the unrealized receivables and inventory items distributed, and if no other property is distributed to which the partner can apply the remaining basis, the partner has a capital loss to the extent of the remaining basis of the partnership interest.

h. Special adjustment to basis

A partner who acquired any part of his or her partnership interest in a sale or exchange or upon the death of another partner may be able to choose a special basis adjustment for property distributed by the partnership. To choose the special adjustment, the partner must have received the distribution within 2 years after acquiring the partnership interest. Also, the partnership must not have chosen the optional adjustment to basis, discussed later.

If a partner chooses this special basis adjustment, the partner's basis for the property distributed is the same as it would have been if the partnership had chosen the optional adjustment to basis. However, this assigned basis is not reduced by any depletion or depreciation that would have been allowed or allowable if the partnership had previously chosen the optional adjustment.

The choice must be made with the partner's tax return for the year of the distribution if the distribution includes any property subject to depreciation, depletion, or amortization. If the choice does not have to be made for the distribution year, it must be made with the return for the first year in which the basis of the distributed property is pertinent in determining the partner's income tax.

A partner choosing this special basis adjustment must attach a statement to his or her tax return that the partner chooses under § 732(d) of the Internal Revenue Code to adjust the basis of property received in a distribution. The statement must show the computation of the special basis adjustment for the property distributed and list the properties to which the adjustment has been allocated.

Example.

Bob purchased a 25% interest in X partnership for $17,000 cash. At the time of the purchase, the partnership owned inventory having a basis to the partnership of $14,000 and a fair market value of $16,000. Thus, $4,000 of the $17,000 he paid was attributable to his share of inventory with a basis to the partnership of $3,500.

Within 2 years after acquiring his interest, Bob withdrew from the partnership and for his entire interest received cash of $1,500, inventory with a basis to the partnership of $3,500, and other property with a basis of $6,000. The value of the inventory received was 25% of the value of all partnership inventory. (It is immaterial whether the inventory he received was on hand when he acquired his interest.)

Since the partnership from which Bob withdrew did not make the optional adjustment to basis, he chose to adjust the basis of the inventory received. His share of the partnership's basis for the inventory is increased by $500 (25% of the $2,000 difference between the $16,000 fair market value of the inventory and its $14,000 basis to the partnership at the time he acquired his interest). The adjustment applies only for purposes of determining his new basis in the inventory, and ***not*** *for purposes of partnership gain or loss on disposition.*

The total to be allocated among the properties Bob received in the distribution is $15,500 ($17,000 basis of his interest - $1,500 cash received). His basis in the inventory items is $4,000 ($3,500 partnership basis + $500 special adjustment). The remaining $11,500 is allocated to his new basis for the other property he received.

7. Mandatory adjustment

A partner does not always have a choice of making this special adjustment to basis. The special adjustment to basis ***must*** be made for a distribution of property, (whether or not within 2 years after the partnership interest was acquired) if all the following conditions existed when the partner received the partnership interest.

- The fair market value of all partnership property (other than money) was more than 110% of its adjusted basis to the partnership;

- If there had been a liquidation of the partner's interest immediately after it was acquired, an allocation of the basis of that interest under the general rules (discussed earlier under *Basis divided among properties*) would have decreased the basis of property that could not be depreciated, depleted, or amortized and increased the basis of property that could be; or

- The optional basis adjustment, if it had been chosen by the partnership, would have changed the partner's basis for the property actually distributed.

a. Required statement

Generally, if a partner chooses a special basis adjustment and notifies the partnership, or if the partnership makes a distribution for which the special basis adjustment is mandatory, the partnership must provide a statement to the partner. The statement must provide information necessary for the partner to compute the special basis adjustment.

IV. Limited Liability Companies

A. DISTRIBUTIONS

1. Pre-Dissolution Distributions

Pre-dissolution distributions (also known as “interim distributions”) are governed by a company’s own operating agreement. Arizona law, for example, § 29-703, provides that “*a limited liability company shall make distributions of cash or other property to its members before the dissolution and winding up of the limited liability company to the extent and at the times or on the occurrence of the events specified in an operating agreement*.”

Table 2 **Summary of LLC Member's Rights to Distributions**

Member Interest	Rule
Timing of Distributions	Made at times provided in the entity's operating agreement
Amount of Distributions	Determined by formula set forth in company's operating agreement or, in the absence thereof, applicable state default provisions
Type of Distributions	Normally cash only; no right to demand "in-kind" distributions unless expressly provided in operating agreement
Transferability of Rights to Distributions	Members are free to transfer or assign their right to distributions without consent of other members unless expressly prohibited

a. Formula for calculating amount of distributions

Members of a limited liability company are free to split profits based on any formula they select. A company that has its own formula for profit-sharing will generally include it as part of their written Articles of Organization or operating agreement. As with most other aspects of limited liability companies, however, each state has a "default" rule that governs how profits are distributed to members in the absence of a specific provision in the company's operating agreement. States generally take one of two approaches in their default rule:

- Members receive distributions in proportion to the contribution they made to the company; or
- Members share equally in the profits of the company, regardless of the specific financial contribution of each member.

The latter is the approach taken by the Uniform Limited Liability Company Act, § 405, which provides, in part, that "any distributions made by a limited liability company before its dissolution and winding up must be in equal shares." This is the same approach that is taken in default rules governing distributions of a partnership.

The drafters of the ULLCA explain the rationale for their default provision in the Comment to § 405, which provides:

> *"Recognizing the informality of many limited liability companies, this section creates a simple default rule regarding interim distributions. Any interim distributions made must be in equal shares and approved by all members. The rule assumes that: profits will be shared equally; some distributions will constitute a return of contributions that should be shared equally rather than a distribution of profits; and property contributors should have the right to veto any distribution that threatens their return of contributions on liquidation. In the simple case where the members make*

equal contributions of property or equal contributions of services, those assumptions avoid the necessity of maintaining a complex capital account or determining profits. Where some members contribute services and others property, the unanimous vote necessary to approve interim distributions protects against unwanted distributions of contributions to service contributors. Consistently, Section 408(a) does not require the company to maintain a separate account for each member, the Act does not contain a default rule for allocating profits and losses, and Section 806(b) requires that liquidating distributions to members be made in equal shares after the return of contributions not previously returned."

When a contribution is made in cash, valuation is not an issue. When a contribution is made in some other form, however, such as real property, there can sometimes be an issue as to the distributive share that a member should receive. In such cases, if the company's operating agreement fails to provide guidance, look to see whether the state of organization provides some formula for determining value.

The following general rules should be applied to non-cash contributions in the absence of any other statutory guidance:

- The value of a capital contribution of services is the fair market value of the services at the time they are rendered;

- The value of a capital contribution of property other than cash is the fair market value of the property at the time of its transfer to the limited liability company; and

- The value of a capital contribution of the use of property is the fair market value of the use of the property during the period that the limited liability company enjoyed possession or use of the property.

b. Limitations on distributions

ULLCA § 406 governs distributions declared or made when the company is insolvent. It provides that distributions may NOT be made in the following circumstances:

- The limited liability company would not be able to pay its debts as they become due in the ordinary course of business; or

- The company's total assets would be less than the sum of its total liabilities plus the amount that would be needed, if the company were to be dissolved, wound up, and terminated at the time of the distribution, to satisfy the preferential rights upon dissolution, winding up, and termination of members whose preferential rights are superior to those receiving the distribution.

ULLCA § 406 further provides the methods that can be used to determine financial insolvency, stating that the company can base its findings "on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances or on a fair valuation or other method that is reasonable in the circumstances."

The Comment to ULLCA § 406 recognizes special accounting problems that can be associated with the timing of a distribution, and provides, in part, as follows:

> *"The application of the equity insolvency and balance sheet tests present special problems in the context of the purchase, redemption, or other acquisition of a company's distributional interests. Special rules establish the time of measurement of such transfers. Under Section 406(c)(1), the time for measuring the effect of a distribution to purchase a distributional interest is the date of payment. The company may make payment either by transferring property or incurring a debt to transfer property in the future. In the latter case, subsection (c)(1) establishes a clear rule that the legality of the distribution is tested when the debt is actually incurred, not later when the debt is actually paid. Under Section 406(e), indebtedness is not considered a liability for purposes of subsection (a) if the terms of the indebtedness itself provide that payments can be made only if and to the extent that a payment of a distribution could then be made under this section. The effect makes the holder of the indebtedness junior to all other creditors but senior to members in their capacity as members."*

In determining whether a company was able to make a distribution, the effect of the distribution is normally measured as of the date on which the money or other property is transferred, or indebtedness payable in installments or otherwise is incurred, by the limited liability company. Other, more specific formulas may be provided in applicable state law.

c. Effect of wrongful distributions

The personal liability of members of a limited liability company was discussed in detail in Chapter 5. The general rule is that a member of a limited liability company is not personally liable for the debts of the company except in certain limited circumstances. One circumstance, however, in which a member can face personal liability is in the event he or she participates in an unlawful distribution of company assets. In such a case, the member becomes liable to the company as a whole rather than a third party.

As usual, refer to the specific laws of each state to determine the precise circumstances under which a member will be personally liable. Under Michigan law, for example, a member or manager who assents to or votes for a wrongful distribution is personally liable to the company for the amount of any distribution that exceeds that which could have been made lawfully under their state law or the company's own operating agreement (M.C.L.A. §450.4308).

Michigan law assumes that any member or manager who participates in a decision to approve a distribution has knowledge that the distribution is wrongful. This legal presumption can only be overcome if the member or manager files a written dissent with the limited liability company within a reasonable period of time. Members who accept a distribution with knowledge that it was improper are also liable for the amount that exceeds the amount they were legally entitled to receive.

The rules under the Uniform Limited Liability Company Act, § 407, are similar. The Comment to § 407 provides that only the company itself, not its creditors, have a right to recovery in the event of a wrongful dissolution. This section also provides that members who both vote for or assent to an unlawful distribution and receive a portion or all of the distribution will be liable, at the election of the company, under either but not both subsections.

A member who is held liable for an unlawful distribution will normally be able, under applicable state law, to seek a contribution from other offending members. Florida law, for example, F.S.A. § 608.426, provides:

(1) The limited liability company may make distributions to its members in accordance with the provisions contained in the operating agreement, except that no distribution may be made if after the distribution the limited liability company would be insolvent. If the operating agreement does not provide for the payment of distributions to members, the distributions shall be made on the basis of the agreed value, as stated in the records of the limited liability company, of the contributions made by each member to the extent they have been received by the limited liability company and have not been returned.

(2) The managers or managing members of a limited liability company may base a determination that a distribution is not prohibited under subsection (1) either on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances or on a fair valuation or other method that is reasonable in the circumstances. In the case of any distribution based upon such financial statement or such a valuation, each such distribution shall be identified as a distribution based upon such financial statements or a fair valuation of assets, and the amount distributed shall be disclosed to the receiving members concurrent with their receipt of the distribution.

(3) A manager or managing member who votes for or assents to a distribution made in violation of this section, the articles of incorporation, or the operating agreement, is personally liable to the limited liability company for the amount of the distribution that exceeds what could have been distributed without such violation if it is established that the manager or managing member did not perform the manager's or managing member's duties in compliance with s. 608.4225. In any proceeding commenced under this section, a manager or managing member has all of the defenses ordinarily available to a manager or managing member.

(4) A manager or managing member held liable under subsection (3) for an unlawful distribution is entitled to contribution:

(a) From every other manager or managing member who is also liable under subsection (3) for the unlawful distribution; and

(b) From each member to the extent of the amount the member accepted knowing the distribution was made in violation of this section, the articles of incorporation, or the operating agreement.

(5) A proceeding under this section is barred unless it is commenced within 2 years after the date on which the distribution was made. In the case of a distribution in the form of indebtedness, each payment of principal or interest is treated as a distribution.

Case-in-Point

A recent case dealing with liability for an improper distribution was ***Imperial Trading Co, Inc. v. Uter,*** 837 So.2d 663 (2002), in which a member of an LLC was found personally liable for the return of improper distributions to his wife.

In 1992, Wayne Bunch and Thomas Harmon were operating several Tobacco Mart stores in Louisiana. Each of their stores was a separately organized legal entity, but seemingly all worked under the guise of Tobacco Mart, Inc. Many of the products sold by these Tobacco Mart stores were supplied by the plaintiff, Imperial Trading Company, Inc. In dealing with Imperial, Bunch and Harmon were required to personally guarantee amounts owed on open account. Attorney Michael J. Uter (Uter) represented Bunch and Harmon in the organization of their Tobacco Mart entities.

Being intrigued by the opportunity for success in operating additional tobacco stores, in 1992, Uter contacted Jack Menzie, whom he had represented in several real estate transactions in the past, about the idea of opening additional Tobacco Mart locations in Louisiana and other states. Menzie and his wife, Connie S. Menzie, agreed to inject money into the proposed venture. Later that year, Ms. Menzie contributed $113,244.71 to the venture.

On advice of their accountant, Uter organized the ownership of these stores through limited liability companies, rather than individual corporations. Articles of organization and an initial report were prepared by Uter and filed with the secretary of state's office. Each of the articles of organization indicated that a written operating agreement was executed contemporaneously with it. In the initial reports for these organizations, Uter was listed as the registered agent for service of process and the initial manager. Tax returns disclosed ownership of Vidalia L.L.C. and Mississippi L.L.C. in Bunch (12.5 percent), Harmon (12.5 percent), Ms. Menzie (36.5 percent), Brennan Uter (36.5 percent), Menzie (1 percent), and Uter (1 percent).

Subsequently, Uter and Menzie were introduced to Imperial's president by Bunch and Harmon. In light of Bunch and Harmon's recommendation that Imperial do business with Uter and Menzie and considering the potential for profit, Imperial established a line of credit in the amount of $50,000 for the purchase of products for several Tobacco Mart stores.

The indebtedness associated with these lines of credit was evidenced by separate promissory notes signed by Uter and Menzie, in a dual capacity, individually and on behalf of the specified store. Security was given for the payment of these notes by a general security agreement also executed by Uter and Menzie in a dual capacity. Imperial supplied tobacco to 14 different stores in Louisiana, Mississippi and Tennessee.

In the summer of 1994, Uter was contacted by an Imperial representative regarding the payment on their open accounts and the possible termination of delivery of products. Around that same time, Menzie and Ms. Menzie decided they would withdraw from the businesses because of the financial status of the businesses. In June 1994, Ms. Menzie withdrew $263,852.48 from various Tobacco Mart checking accounts, which she asserted was a return of her investment and/or repayment of the loans she had made to the venture, with eight percent interest.

The assets of some of the stores were sold later that year to help pay the debt to Imperial. Imperial began making deliveries on a C.O.D. basis only until the parties were able to reach an agreement on repayment.

Imperial eventually filed suit seeking recovery for unpaid balances on their account. In addition to finding the company liable for the open book account, the court found that the payments in 1994 to Ms. Menzie left the company unable to meet its financial obligations and therefore constituted a violation of state law. It therefore ordered a return of the money.

Relative to interim distributions, LSA-R.S. 12:1324 provides:

A. Except as provided in this Chapter, a member is entitled to receive distributions from a limited liability company before the withdrawal of the member from the limited liability company and before the dissolution and winding up of the limited liability company to the extent and at the times or upon the occurrence of the events provided in an operating agreement or as authorized by the members.

B. Interim distribution of cash or other assets of a limited liability company shall be allocated among the members and among classes of members in the manner provided in a written operating agreement. To the extent such operating agreement does not so provide in writing, distributions shall be made equally to the members.

However, restrictions are placed on the making of any distributions by LSA-R.S. 12:1327(A), which provides:

No distribution shall be made if, after giving effect to the distribution:

(1) The limited liability company would not be able to pay its debts as they become due in the usual course of business.

(2) The limited liability company's total assets would be less than the sum of its total liabilities plus, unless the articles of organization or a written operating agreement provides otherwise, the amount that would be needed if the limited liability company were to be dissolved at the time of the distribution to satisfy the preferential rights of other members upon dissolution which are superior to the rights of the member receiving the distribution.

The court therefore found the distribution to be in violation of state law. The court also found Mr. Menzie to be jointly liable for the return of the illegal distribution based on LSA-R.S. 12:1328, which imposes joint and several liability on the members or managers of a limited liability company who knowingly, or without the exercise of reasonable care and inquiry, vote for or assent to a distribution in violation of LSA-R.S. 12:1327. Such liability falls on each member, if management is reserved to the members, or each manager, if management is vested in one or more managers.

Although the record does not reveal a knowing violation of the statute, the court said it reasonably supports a finding that such distributions were made without the exercise of reasonable care and inquiry as to whether they were wrongful, as defined by the statute.

d. Transferability of distributional interest

While members of a limited liability company do not have an interest in any of the specific assets of the company, they do have an interest in the distributions to which they are entitled as members. This interest is the personal property of the member and therefore is freely transferable – absent a contrary provision in the company's articles of organization or operating agreement – under the ULLCA, § 501, as well as the laws of all states.

Remember that while a member normally enjoys the right to transfer, assign or otherwise dispose of their right to the distributions of a limited liability company in which they are a member, they normally do not have such liberal rights to transfer their actual membership in the company.

Florida law, for example, F.S.A. § 608.432, provides, in part:

(1) A limited liability company interest is assignable in whole or in part except as provided in the articles of organization or operating agreement. The assignee of a member's interest shall have no right to participate in the management of the business and affairs of a limited liability company except as provided in the articles of organization or operating agreement and upon:

(a) The approval of all of the members of the limited liability company other than the member assigning the limited liability company interest; or

(b) Compliance with any procedure provided for in the articles of organization or operating agreement.

(2) Unless otherwise provided in the articles of organization or operating agreement:

(a) An assignment of a membership interest does not entitle the assignee to become or to exercise any rights or powers of a member;

(b) An assignment of a membership interest entitles the assignee to share in such profits and losses, to receive such distribution or distributions, and to receive such allocation of income, gain, loss, deduction, or credit or similar item to which the assignor was entitled, to the extent assigned.

e. In kind distributions

States normally do not allow a member of a limited liability company to demand an in kind distribution unless expressly provided in the company's operating agreement. This is consistent with the concept of a limited liability company as an entity. This is also consistent with the rules for limited partnerships.

The limitation on the right to demand in kind distributions applies normally regardless of what type of contribution was made by a member to the company (e.g. Pennsylvania Statutes § 8934, provides: "*A member, regardless of the nature of the contribution of the member, has no right to demand and receive any distribution from a limited liability company in any form other than cash.*")

2. Treatment Of Excess Contributions

In the event a member of a limited liability company provides an advance to the company in an amount greater than the amount of contribution agreed upon, the company is liable to the member for the difference. This amount is often treated as a loan, and therefore requires the company to pay the member interest accruing from the date the payment was made.

On the other hand, members are normally not entitled to compensation for their personal services performed for the benefit of the company, other than those performed in winding up the company's business, except as otherwise provided in the entity's operating agreement.

3. Post-Dissolution Distributions

When a limited liability company either chooses to or is forced to dissolve, e.g. through judicial or administrative action, the assets of the company must be disposed of. The issue of dissolution will be discussed in more detail in Chapter 10. This discussion focuses on the distribution of assets only.

When a limited liability company winds up its business, all creditors – including members who are creditors – must be paid before distributions can be made to members. Any remaining assets are then distributed according to each member’s general rights to distributions as provided in the company’s operating agreement or the applicable state’s default provisions.

B. FEDERAL TAX TREATMENT OF DISTRIBUTIONS

For federal tax purposes, a limited liability company can be treated either as a sole proprietorship, a partnership or a corporation. In order to elect treatment as a partnership, a limited liability company must have at least two members. Those with only one can elect to be treated either as a sole proprietorship or a corporation.

Consequently, the applicable tax payment requirements of a limited liability company – as discussed above – depend on the tax treatment elected by the company. To the extent that a limited liability company elects to be treated as a partnership for purposes of federal taxation, normal rules governing taxation of partnerships discussed earlier in this chapter apply. To the extent a limited liability company elects to be treated as a corporation for purposes of federal taxation, normal rules governing taxation of corporations likewise generally apply.

Each LLC member's share of profits and losses, called a distributive share, is set out in the LLC operating agreement. Most operating agreements provide that a member's distributive share is in proportion to his percentage interest in the business. For instance, if Bill owns 70% of the LLC, and John owns the other 30%, Bill will be entitled to 70% of the LLC's profits and losses, and John will be entitled to the other 30%. If the members want to divide profits and losses in a manner that is not proportionate to the members' percentage interests in the business, it is called a "special allocation," and must comply with specific IRS rules.

Distributions to equity owners of businesses taxed as partnerships are normally not subject to income tax pursuant to IRC § 731, which provides, in part, that "gain shall not be recognized . . . except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution."

Any gain recognized is generally treated as capital gain from the sale of the partnership interest on the date of the distribution. If partnership property (other than marketable securities treated as money) is distributed to a partner, he or she generally does not recognize any gain until the sale or other disposition of the property.

Example.

The adjusted basis of Jo's partnership interest is $14,000. She receives a distribution of $8,000 cash and land that has an adjusted basis of $2,000 and a fair market value of $3,000. Because the cash received does not exceed the basis of her partnership interest, Jo does not recognize any gain on the distribution. Any gain on the land will be recognized when she sells or otherwise disposes of it. The distribution decreases the adjusted basis of Jo's partnership interest to $4,000 [$14,000 - ($8,000 + $2,000)].

Likewise, I.R.C. §731 provides that a member of a limited liability company may not declare a loss "except that upon a distribution in liquidation of a partner's interest in a partnership where no property other than that described in subparagraph (A) or (B) is distributed to such partner, loss shall be recognized to the extent of the excess of the adjusted basis of such partner's interest in the partnership over the sum of: (A) any money distributed; and (B) the basis to the distributee."

In addition, passive activity limitations and at-risk rules that apply to partnerships generally may restrict the amount a member of a limited liability company may deduct.

1. <u>At-Risk Rules</u>

The at risk rules of I.R.C. § 465 provide that the members are allowed to deduct their shares of LLC losses to the extent they have an adequate amount at risk in the relevant activity. Generally, nonrecourse debt is not included in the amount at risk, but an exception exists for "qualified nonrecourse financing,'' which typically exists when a commercial lender makes a nonrecourse loan secured by real property.

Unlike a limited partnership in which the general partner is fully liable for partnership obligations, in an LLC no member may be liable for the LLC's obligations (except to the extent a member has separately agreed to assume them). Accordingly, even if the debt of an LLC is nominally recourse at the entity level, it may be nonrecourse to the members, thereby making it easier for LLC debt secured by real property to constitute "qualified nonrecourse financing.''

Case-in-Point

In a case of first impression, a federal district court in ***Gregg v. U.S.***, 186 F.Supp.2d 1123 (2000) ruled that a member of a limited liability company was entitled to be treated like a general rather than a limited partner for purposes of determining whether he was an active participant in the business and therefore not subject to passive income limits.

The case arose in response to an I.R.S. audit of plaintiff's income tax return. It disallowed his characterization of flow-through loss from the limited liability company of which he was a member as an ordinary loss and re-characterized that loss as a passive activity loss. The issue was whether plaintiff's ratable share of the flow-through operating loss from the LLC should be characterized as ordinary loss or passive activity loss in plaintiffs' joint tax return.

Ordinary losses can be applied against any income; however, passive activity losses can be applied only against passive activity income. Passive activity losses that are not currently deductible are carried forward to the next taxable year. The IRS characterized plaintiff's flow-through loss from the limited liability company of which he was a member as a passive activity loss, thus limiting any deductions to applicable passive gains.

In general, a "passive activity" is one in which the taxpayer does not "materially participate." The IRS has specific regulations which govern whether a taxpayer has materially participated in the business. Those regulations differentiate between general and limited partners, making it much more difficult for a limited partner to be considered an active participant in the business than a general partner.

The IRS argued that a member of a limited liability company should be treated as a limited partner because members of an LLC, like limited partners, are not personally liable for the debts and obligations of the entity.

The plaintiff, on the other hand, said existing IRS regulations governing partnerships were obsolete as applied to limited liability companies because of the unique characteristics of the relatively new type of business entity. The court agreed with the plaintiff, writing:

> *A limited partnership must have at least one general partner who is personally liable for the obligation of the limited partnership. If, for federal tax purposes, an LLC is treated as a limited partnership, and all members of the LLC are treated as limited partners because of their limited liability, the consequence of such a treatment does not satisfy the requirement of 'at least one general partner.' In addition, LLC members retain their limited liability regardless of their level of participation in the management of the LLC. But a limited partner in a limited partnership cannot, by definition, participate in the management.*

“Furthermore, the legislative history clearly shows that Congress enacted the limited partnership test for the purpose of the passive activity loss rules to thwart the deduction by investors, such as limited partners in a limited partnership, of ‘passive’ losses from ‘tax shelter’ investments against other non-passive income, since ‘a limited partner generally is precluded from participating in the partnership's business if he is to retain his limited liability status[.]’”

The limited partnership test is not applicable to all LLC members. Because LLCs are designed to permit active involvement by LLC members in the management of the business, the court concluded that the limited partnership test is not applicable to all LLC members. Further, the court said, LLC members – unlike limited partners – may materially participate in the LLC without losing their limited liability protection. “In the absence of any regulation asserting that an LLC member should be treated as a limited partner of a limited partnership,” the court said, “defendant's conclusion is inappropriate. Therefore, the higher standard of material participation test for limited partners should not be applied to plaintiff.”

2. Retained Earnings

The benefits of pass-through taxation available to most limited liability companies are obvious. However, there are certain circumstances under which an LLC might benefit from corporate tax status, depending on the nature of the business. One situation where this might be true is when a company has a large amount of retained earnings, that is when a company elects to keep a substantial amount of profits in the company rather than distributing it to its members.

Unlike an LLC, a corporation is responsible for paying taxes on corporate profits left or retained in the business. An LLC that elects corporate tax status, therefore, means that the company will pay tax on the earnings based on the income tax rates that apply to corporations. The members do not have to pay personal income taxes on those profits which are left in the company. And, because the corporate income tax rates for the first $75,000 of corporate taxable income are lower than the individual income tax rates that apply to most LLC owners, this can save you and your co-owners money in overall taxes.

Example.

If your LLC needs to purchase expensive equipment at the beginning of each year, it may decide to leave $50,000 in the business at the end of the year. With the regular pass-through taxation of an LLC, these retained profits would probably be taxed at the member’s individual tax rate, which is probably over 27%. But with corporate taxation, that $50,000 is taxed at the lower 15% corporate rate.

A limited liability company that elects corporate tax status by filing Form 8832 is precluded from switching back to partnership status for five years.

V. <u>Corporations</u>

Unlike some of the other business entities this course has discussed, a corporation is a legal entity separate and apart from its shareholders. As such – with the exception of subchapter S corporations, which will be discussed below – the profits of a corporation are taxed to the corporation at the applicable tax level. On the other hand, when profits are distributed to shareholders – normally through the issuance of a dividend – shareholders become individually liable for the income they receive. This section will first discuss shareholders' "right" to receive dividends and then discuss issues affecting the taxation of dividends and salaries of shareholder-employees.

A. SHAREHOLDERS' RIGHT TO DIVIDENDS

Even assuming that a corporation is profitable, the owners are not necessarily entitled to personally share in the profits. The general rule of law is that shareholders are not entitled to a dividend. The discretion to grant a dividend lies solely with the corporation's Board of Directors. Only in a few very limited situations – normally involving closely-held corporations – have shareholders been successful in compelling dividends.

However, it is also important to note here that while it cannot normally be compelled, the failure of a closely-held corporation to pay a dividend can, in some circumstances, lead to tax penalties when the failure is the result of a desire to avoid federal taxation pursuant to IRC § 531, below:

I.R.C. § 531. *Imposition of accumulated earnings tax*

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income (as defined in § 535) of each corporation described in section 532, an accumulated earnings tax equal to 15 percent of the accumulated taxable income.

I.R.C. § 532 provides that the penalty set forth in § 531 applies to any corporation formed for the purpose of avoiding income taxation of its shareholders with the following exceptions:

- Certain holding companies (as defined in § 542);
- A corporation exempt from tax under subchapter F (§ 501 and following);
- A foreign personal holding company (as defined in § 552),
- A passive foreign investment company (as defined in §1297).

The number of shareholders in a corporation is not a factor in determining applicability of the tax in § 531. However, § 533, below, sets forth rules regarding the type of evidence that is sufficient to prove a purpose to avoid income tax. The test focuses on the "reasonable" need of the corporation for the retained earnings (§ 537 sets forth criteria for determining the reasonable needs of the business).

Section 533. ***Evidence of purpose to avoid income tax***

(a) For purposes of section 532, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary.

(b) The fact that any corporation is a mere holding or investment company shall be prima facie evidence of the purpose to avoid the income tax with respect to shareholders.

B. LIMITATIONS ON DIVIDENDS

As we saw with partnerships and limited liability companies, there are circumstances in which a corporation is prohibited from issuing a dividend, even if approved by its Board of Directors. These limitations almost always involve protecting the solvency of the corporation.

C. CORPORATE SALARIES

One way corporations avoid the double-taxation of dividends is by making shareholders employees and paying them a salary. The employee is of course taxed on his or her income as is any other employee, but the corporation is entitled to deduct the salary as an ordinary business expense. This is an option most used in small, closely-held corporations where the shareholders are also employees.

There are, however, limitations on this practice. The main limitation is that corporations are not entitled to deduct as a business expense so-called “excessive” salaries. This rule is in place to prohibit shareholders from avoiding paying tax on dividends by passing profits through as salary or other compensation, such as bonuses.

I.R.C. § 162 provides the general right of a corporation to deduct the salaries of employees as an ordinary expense:

(a) In general. – There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including--
(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(m) Certain excessive employee remuneration.—
(1) In general – In the case of any publicly held corporation, no deduction shall be allowed under this chapter for applicable employee remuneration with respect to any covered employee to the extent that the amount of such remuneration for the taxable year with respect to such employee exceeds $1,000,000.

With respect to non-publicly traded corporations, the excessiveness of a corporate salary or other remuneration is measured from the perspective of the independent investor, as provided in the following treasury regulation:

§ 1.162-7 Compensation for personal services

(a) There may be included among the ordinary and necessary expenses paid or incurred in carrying on any trade or business a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.

(b) The test set forth in paragraph (a) of this section and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

(2) The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

(4) For disallowance of deduction in the case of certain transfers of stock pursuant to employees stock options, see section 421 and the regulations thereunder.

Case-in-Point

In ***Exacto Spring Corp. v. C.I.R.*** (196 F.3d 833, C.A., 1999), the court interpreted 26 U.S.C. § 162(a)(1).

In 1993 and 1994, Exacto Spring Corporation, a closely held corporation engaged in the manufacture of precision springs, paid its cofounder, chief executive, and principal owner, William Heitz, $1.3 and $1.0 million, respectively, in salary. The Internal Revenue Service ruled that the compensation was excessive, finding that Heitz should not have been paid more than $381,000 in 1993 or $400,000 in 1994.

Exacto challenged the IRS's determination in the Tax Court. That court found that the maximum reasonable compensation for Heitz would have been $900,000 in the earlier year and $700,000 in the later one. Exacto appealed.

In reaching its conclusion, the Tax Court applied a test that requires the consideration of seven factors, none entitled to any specified weight relative to another. The factors are, in the court's words, "(1) the type and extent of the services rendered; (2) the scarcity of qualified employees; (3) the qualifications and prior earning capacity of the employee; (4) the contributions of the employee to the business venture; (5) the net earnings of the employer; (6) the prevailing compensation paid to employees with comparable jobs; and (7) the peculiar characteristics of the employer's business."

The appeals court noted that the test does not give any indication of how the factors are to be weighed and that some are also vague. The court said in determining whether executive compensation is excessive, it should be evaluated from the perspective of the "independent investor."

"A corporation can be conceptualized as a contract in which the owner of assets hires a person to manage them. The owner pays the manager a salary and in exchange the manager works to increase the value of the assets that have been entrusted to his management; that increase can be expressed as a rate of return to the owner's investment," the court wrote. "The higher the rate of return (adjusted for risk) that a manager can generate, the greater the salary he can command. If the rate of return is extremely high, it will be difficult to prove that the manager is being overpaid, for it will be implausible that if he quit if his salary was cut, and he was replaced by a lower-paid manager, the owner would be better off; it would be killing the goose that lays the golden egg."

In this case, the court found that the expected return for an investor in a firm such as Exacto would be 13 percent. Since the actual return was 20 percent, the court said the salary was "presumptively" reasonable:

"We say 'presumptively,'" the court wrote, "because we can imagine cases in which the return, though very high, is not due to the CEO's exertions. Suppose Exacto had been an unprofitable company that suddenly learned that its factory was sitting on an oil field, and when oil revenues started to pour in its owner raised his salary from $50,000 a year to $1.3 million. The presumption of reasonableness would be rebutted. There is no suggestion of anything of that sort here and likewise no suggestion that Mr. Heitz was merely the titular chief executive and the company was actually run by someone else, which would be another basis for rebuttal."

The court did go on to say that the IRS could still have won its case if it had been able to show that the company did not in fact intend to pay Heitz that amount as salary, that his salary really did include a concealed dividend though it need not have. “This is material (and the "independent investor" test, like the multi-factor test that it replaces, thus incomplete, though invaluable),” the court said, “because any business expense to be deductible must be, as we noted earlier, a bona fide expense as well as reasonable in amount. The fact that Heitz's salary was approved by the other owners of the corporation, who had no incentive to disguise a dividend as salary, goes far to rebut any inference of bad faith here, which in any event the Tax Court did not draw and the government does not ask us to draw.”

VI. Subchapter S Corporations

The essence of the subchapter S corporation is that profits are “passed through” to shareholders directly, just as distributions in a partnership. Thus, by making the election under subchapter S, the corporation retains all the advantages of operating in corporate form, without suffering the form's greatest disadvantage: double taxation. The subchapter S corporation is a pass- through entity, similar in its tax treatment to partnerships.

A. ELECTING S CORPORATION STATUS

Timing of the election can be critical in limiting one’s tax liability. The rules for timing of an election are set forth in I.R.C. § 1362, below:

I.R.C. § 1362 Election; revocation; termination

(a) Election.—
(1) In general.--Except as provided in subsection (g), a small business corporation may elect, in accordance with the provisions of this section, to be an S corporation.
(2) All shareholders must consent to election.--An election under this subsection shall be valid only if all persons who are shareholders in such corporation on the day on which such election is made consent to such election.
(b) When made.—
(1) In general.--An election under subsection (a) may be made by a small business corporation for any taxable year--
(A) at any time during the preceding taxable year, or
(B) at any time during the taxable year and on or before the 15th day of the 3d month of the taxable year.
(2) Certain elections made during 1st 2 1/2 months treated as made for next taxable year.--If--

(A) an election under subsection (a) is made for any taxable year during such year and on or before the 15th day of the 3d month of such year, but

(B) either--

(i) on 1 or more days in such taxable year before the day on which the election was made the corporation did not meet the requirements of subsection (b) of section 1361, or

(ii) 1 or more of the persons who held stock in the corporation during such taxable year and before the election was made did not consent to the election, then such election shall be treated as made for the following taxable year.

(3) Election made after 1st 2 1/2 months treated as made for following taxable year.--If--

(A) a small business corporation makes an election under subsection (a) for any taxable year, and

(B) such election is made after the 15th day of the 3d month of the taxable year and on or before the 15th day of the 3rd month of the following taxable year, then such election shall be treated as made for the following taxable year.

(4) Taxable years of 2 1/2 months or less.--For purposes of this subsection, an election for a taxable year made not later than 2 months and 15 days after the first day of the taxable year shall be treated as timely made during such year.

(5) Authority to treat late elections, etc., as timely.--If--

(A) an election under subsection (a) is made for any taxable year (determined without regard to paragraph (3)) after the date prescribed by this subsection for making such election for such taxable year or no such election is made for any taxable year, and

(B) the Secretary determines that there was reasonable cause for the failure to timely make such election, the Secretary may treat such an election as timely made for such taxable year (and paragraph (3) shall not apply).

(c) Years for which effective.--An election under subsection (a) shall be effective for the taxable year of the corporation for which it is made and for all succeeding taxable years of the corporation, until such election is terminated under subsection (d).

B. TAX TREATMENT OF DISTRIBUTIONS / APPLICATION OF AT-RISK RULES

Once a corporation elects subchapter S status, its income and losses pass through to its shareholders in the same fashion as a partnership. However, the special allocations permitted in partnerships – discussed above – are not allowable in the case of S corporations. This means that a shareholder in an S corporation is not able to increase his or her basis through allocation of the corporation's liabilities.

Losses are also treated the same as with partnerships, although they are limited by a shareholder's basis in stock of the S corporation. These rules are detailed in I.R.C. § 1366 below:

§ 1366. Pass-thru of items to shareholders

(a) Determination of shareholder's tax liability.--

(1) In general.--In determining the tax under this chapter of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends (or for the final taxable year of a shareholder who dies, or of a trust or estate which terminates, before the end of the corporation's taxable year), there shall be taken into account the shareholder's pro rata share of the corporation's--

(A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and

(B) nonseparately computed income or loss.
For purposes of the preceding sentence, the items referred to in subparagraph (A) shall include amounts described in paragraph (4) or (6) of section 702(a).

(2) Nonseparately computed income or loss defined.--For purposes of this subchapter, the term "nonseparately computed income or loss" means gross income minus the deductions allowed to the corporation under this chapter, determined by excluding all items described in paragraph (1)(A).

(b) Character passed thru.--The character of any item included in a shareholder's pro rata share under paragraph (1) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation.

(c) Gross income of a shareholder.--In any case where it is necessary to determine the gross income of a shareholder for purposes of this title, such gross income shall include the shareholder's pro rata share of the gross income of the corporation.

(d) Special rules for losses and deductions.—

(1) Cannot exceed shareholder's basis in stock and debt.--The aggregate amount of losses and deductions taken into account by a shareholder under subsection (a) for any taxable year shall not exceed the sum of--

(A) the adjusted basis of the shareholder's stock in the S corporation (determined with regard to paragraphs (1) and (2)(A) of section 1367(a) for the taxable year), and

(B) the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder (determined without regard to any adjustment under paragraph (2) of section 1367(b) for the taxable year).

(2) Indefinite carryover of disallowed losses and deductions.--

(A) In general.--Except as provided in subparagraph (B), any loss or deduction which is disallowed for any taxable year by reason of paragraph (1) shall be treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder.

(B) Transfers of stock between spouses or incident to divorce.--In the case of any transfer described in section 1041(a) of stock of an S corporation, any loss or deduction described in subparagraph (A) with respect such stock shall be treated as incurred by the corporation in the succeeding taxable year with respect to the transferee.

(3) Carryover of disallowed losses and deductions to post-termination transition period.-

(A) In general.--If for the last taxable year of a corporation for which it was an S corporation a loss or deduction was disallowed by reason of paragraph (1), such loss or deduction shall be treated as incurred by the shareholder on the last day of any post-termination transition period.

(B) Cannot exceed shareholder's basis in stock.--The aggregate amount of losses and deductions taken into account by a shareholder under subparagraph (A) shall not exceed the adjusted basis of the shareholder's stock in the corporation (determined at the close of the last day of the post-termination transition period and without regard to this paragraph).

(C) Adjustment in basis of stock.--The shareholder's basis in the stock of the corporation shall be reduced by the amount allowed as a deduction by reason of this paragraph.

(D) At-risk limitations.--To the extent that any increase in adjusted basis described in subparagraph (B) would have increased the shareholder's amount at risk under section 465 if such increase had occurred on the day preceding the commencement of the post-termination transition period, rules similar to the rules described in subparagraphs (A) through (C) shall apply to any losses disallowed by reason of section 465(a).

(e) Treatment of family group.--If an individual who is a member of the family (within the meaning of section 704(e)(3)) of one or more shareholders of an S corporation renders services for the corporation or furnishes capital to the corporation without receiving reasonable compensation therefor, the Secretary shall make such adjustments in the items taken into account by such individual and such shareholders as may be necessary in order to reflect the value of such services or capital.

(f) Special rules.--

(1) Subsection (a) not to apply to credit allowable under section 34.--
Subsection (a) shall not apply with respect to any credit allowable under section 34 (relating to certain uses of gasoline and special fuels.

(2) Treatment of tax imposed on built-in gains.--If any tax is imposed under section 1374 for any taxable year on an S corporation, for purposes of subsection (a), the amount so imposed shall be treated as a loss sustained by the S corporation during such taxable year. The character of such loss shall be determined by allocating the loss proportionately among the recognized built-in gains giving rise to such tax.

(3) Reduction in pass-thru for tax imposed on excess net passive income.--If any tax is imposed under section 1375 for any taxable year on an S corporation, for purposes of subsection (a), each item of passive investment income shall be reduced by an amount which bears the same ratio to the amount of such tax as--

(A) the amount of such item, bears to

(B) the total passive investment income for the taxable year.

(3) Reduction in pass-thru for tax imposed on excess net passive income.--If any tax is imposed under section 1375 for any taxable year on an S corporation, for purposes of subsection (a), each item of passive investment income shall be reduced by an amount which bears the same ratio to the amount of such tax as--

(A) the amount of such item, bears to

(B) the total passive investment income for the taxable year.

A shareholder in a subchapter S corporation must also carry forward to future taxable years any loss that exceeds the basis limitation, and likewise can deduct only the disallowed loss when and to the extent the owner acquires additional outside basis. The issue was detailed by the IRS in Treas. Reg. §1.133602(a)(2), below:

§ 1.1366-2 Limitations on deduction of passthrough items of an S corporation to its shareholders

(a) In general--(1) Limitation on losses and deductions. The aggregate amount of losses and deductions taken into account by a shareholder under § 1.1366- 1(a)(2), (3), and (4) for any taxable year of an S corporation cannot exceed the sum of—

(i) The adjusted basis of the shareholder's stock in the corporation (as determined under paragraph (a)(3)(i) of this section); and

(ii) The adjusted basis of any indebtedness of the corporation to the shareholder (as determined under paragraph (a)(3)(ii) of this section).

(2) Carryover of disallowance. A shareholder's aggregate amount of losses and deductions for a taxable year in excess of the sum of the adjusted basis of the shareholder's stock in an S corporation and of any indebtedness of the S corporation to the shareholder is not allowed for the taxable year. However, any disallowed loss or deduction retains its character and is treated as incurred by the corporation in the corporation's first succeeding taxable year, and subsequent taxable years, with respect to the shareholder. For rules on determining the adjusted bases of stock of an S corporation and indebtedness of the corporation to the shareholder, see paragraphs (a)(3)(i) and (ii) of this section.

(3) Basis limitation amount--(i) Stock portion. A shareholder generally determines the adjusted basis of stock for purposes of paragraphs (a)(1)(i) and (2) of this section (limiting losses and deductions) by taking into account only increases in basis under section 1367(a)(1) for the taxable year and decreases in basis under section 1367(a)(2)(A), (D) and (E) (relating to distributions, noncapital, nondeductible expenses, and certain oil and gas depletion deductions) for the taxable year. In so determining this loss limitation amount, the shareholder disregards decreases in basis under section 1367(a)(2)(B) and (C) (for losses and deductions, including losses and deductions previously disallowed) for the taxable year. However, if the shareholder has in effect for the taxable year an election under § 1.1367-1(g) to decrease basis by items of loss and deduction prior to decreasing basis by noncapital, nondeductible expenses and certain oil and gas depletion deductions, the shareholder also disregards decreases in basis under section 1367(a)(2)(D) and (E). This basis limitation amount for stock is determined at the time prescribed under § 1.1367-1(d)(1) for adjustments to the basis of stock. (ii) Indebtedness portion. A shareholder determines the shareholder's adjusted basis in indebtedness of the corporation for purposes of paragraphs (a)(1)(ii) and (2) of this section (limiting losses and deductions) without regard to any adjustment under section 1367(b)(2)(A) for the taxable year. This basis limitation amount for indebtedness is determined at the time prescribed under § 1.1367-2(d)(1) for adjustments to the basis of indebtedness.

(4) Limitation on losses and deductions allocated to each item. If a shareholder's pro rata share of the aggregate amount of losses and deductions specified in § 1.1366-1(a)(2), (3), and (4) exceeds the sum of the adjusted basis of the shareholder's stock in the corporation (determined in accordance with paragraph (a)(3)(i) of this section) and the adjusted basis of any indebtedness of the corporation to the shareholder (determined in accordance with paragraph (a)(3)(ii) of this section), then the limitation on losses and deductions under section 1366(d)(1) must be allocated among the shareholder's pro rata share of each loss or deduction. The amount of the limitation allocated to any loss or deduction is an amount that bears the same ratio to the amount of the limitation as the loss or deduction bears to the total of the losses and deductions. For this purpose, the total of losses and deductions for the taxable year is the sum of the shareholder's pro rata share of losses and deductions for the taxable year, and the losses and deductions disallowed and carried forward from prior years pursuant to section 1366(d)(2).

(5) Nontransferability of losses and deductions. Any loss or deduction disallowed under paragraph (a)(1) of this section is personal to the shareholder and cannot in any manner be transferred to another person. If a shareholder transfers some but not all of the shareholder's stock in the corporation, the amount of any disallowed loss or deduction under this section is not reduced and the transferee does not acquire any portion of the disallowed loss or deduction. If a shareholder transfers all of the shareholder's stock in the corporation, any disallowed loss or deduction is permanently disallowed.

(6) Basis of stock acquired by gift. For purposes of section 1366(d)(1)(A) and paragraphs (a)(1)(i) and (2) of this section, the basis of stock in a corporation acquired by gift is the basis of the stock that is used for purposes of determining loss under section 1015(a).

(b) Special rules for carryover of disallowed losses and deductions to post- termination transition period described in section 1377(b)--(1) In general. If, for the last taxable year of a corporation for which it was an S corporation, a loss or deduction was disallowed to

a shareholder by reason of the limitation in paragraph (a) of this section, the loss or deduction is treated under section 1366(d)(3) as incurred by that shareholder on the last day of any post-termination transition period (within the meaning of section 1377(b)).

(2) Limitation on losses and deductions. The aggregate amount of losses and deductions taken into account by a shareholder under paragraph (b)(1) of this section cannot exceed the adjusted basis of the shareholder's stock in the corporation determined at the close of the last day of the post-termination transition period. For this purpose, the adjusted basis of a shareholder's stock in the corporation is determined at the close of the last day of the post-termination transition period without regard to any reduction required under paragraph (b)(4) of this section. If a shareholder disposes of a share of stock prior to the close of the last day of the post-termination transition period, the adjusted basis of that share is its basis as of the close of the day of disposition. Any losses and deductions in excess of a shareholder's adjusted stock basis are permanently disallowed. For purposes of section 1366(d)(3)(B) and this paragraph (b)(2), the basis of stock in a corporation acquired by gift is the basis of the stock that is used for purposes of determining loss under section 1015(a).

(3) Limitation on losses and deductions allocated to each item. If the aggregate amount of losses and deductions treated as incurred by the shareholder under paragraph (b)(1) of this section exceeds the adjusted basis of the shareholder's stock determined under paragraph (b)(2) of this section, the limitation on losses and deductions under section 1366(d)(3)(B) must be allocated among each loss or deduction. The amount of the limitation allocated to each loss or deduction is an amount that bears the same ratio to the amount of the limitation as the amount of each loss or deduction bears to the total of all the losses and deductions.

(4) Adjustment to the basis of stock. The shareholder's basis in the stock of the corporation is reduced by the amount allowed as a deduction by reason of this paragraph (b). For rules regarding adjustments to the basis of a shareholder's stock in an S corporation, see § 1.1367-1.

(c) Carryover of disallowed losses and deductions in the case of liquidations, reorganizations, and divisions--(1)Liquidations and reorganizations. If a corporation acquires the assets of an S corporation in a transaction to which section 381(a) applies, any loss or deduction disallowed under paragraph (a) of this section with respect to a shareholder of the distributor or transferor S corporation is available to that shareholder as a shareholder of the acquiring corporation. Thus, where the acquiring corporation is an S corporation, a loss or deduction of a shareholder of the distributor or transferor S corporation disallowed prior to or during the taxable year of the transaction is treated as incurred by the acquiring S corporation with respect to that shareholder if the shareholder is a shareholder of the acquiring S corporation after the transaction. Where the acquiring corporation is a C corporation, a post- termination transition period arises the day after the last day that an S corporation was in existence and the rules provided in paragraph (b) of this section apply with respect to any shareholder of the acquired S corporation that is also a shareholder of the acquiring C corporation after the transaction. See the special rules under section 1377 for the availability of the post-termination transition period if the acquiring corporation is a C corporation.

(2) Corporate separations to which section 368(a)(1)(D) applies. If an S corporation transfers a portion of its assets constituting an active trade or business to another corporation in a transaction to which section 368(a)(1)(D) applies, and immediately thereafter the stock and securities of the controlled corporation are distributed in a distribution or exchange to which section 355 (or so much of section 356 as relates to section 355) applies, any loss or deduction disallowed under paragraph (a) of this section with respect to a shareholder of the distributing S corporation immediately before the transaction is allocated between the distributing corporation and the controlled corporation with respect to the shareholder. Such allocation shall be made according to any reasonable method, including a method based on the relative fair market value of the shareholder's stock in the distributing and controlled corporations immediately after the distribution, a method based on the relative adjusted basis of the assets in the distributing and controlled corporations immediately after the distribution, or, in the case of losses and deductions clearly attributable to either the distributing or controlled corporation, any method that allocates such losses and deductions accordingly.

C. ACCUMULATED PROFITS

An S corporation is likely to accumulate earnings in only one of two ways: (1) where the S corporation acquires the assets of a C corporation; or (2) where the S corporation was formerly a C corporation. If a subchapter S corporation has accumulated earnings and profits, then the tax treatment of distributions is governed by § 1368(c):

§ 1.1368-1 Distributions by S Corporations.

(a) In general. This section provides rules for distributions made by an S corporation with respect to its stock which, but for section 1368(a) and this section, would be subject to section 301(c) and other rules of the Internal Revenue Code that characterize a distribution as a dividend.

(b) Date distribution made. For purposes of section 1368, a distribution is taken into account on the date the corporation makes the distribution, regardless of when the distribution is treated as received by the shareholder.

(c) S corporation with no earnings and profits. A distribution made by an S corporation that has no accumulated earnings and profits as of the end of the taxable year of the S corporation in which the distribution is made is treated in the manner provided in section 1368(b).

(d) S corporation with earnings and profits--(1) General treatment of distribution. Except as provided in paragraph (d)(2) of this section, a distribution made with respect to its stock by an S corporation that has accumulated earnings and profits as of the end of the taxable year of the S corporation in which the distribution is made is treated in the manner provided in section 1368(c). See section 316 and § 1.316-2 for provisions relating to the allocation of earnings and profits among distributions.

(2) Previously taxed income. This paragraph (d)(2) applies to distributions by a corporation that has both accumulated earnings and profits and previously taxed income (within the meaning of section 1375(d)(2), as in effect prior to its amendment by the Subchapter S Revision Act of 1982, and the regulations thereunder) with respect to one or more shareholders. In the case of such a distribution, that portion remaining after the

application of section 1368(c)(1) (relating to distributions from the accumulated adjustments account (AAA) as defined in § 1.1368-2(a)) is treated in the manner provided in section 1368(b) (relating to S corporations without earnings and profits) to the extent that portion is a distribution of money and does not exceed the shareholder's net share immediately before the distribution of the corporation's previously taxed income. The AAA and the earnings and profits of the corporation are not decreased by that portion of the distribution. Any distribution remaining after the application of this paragraph (d)(2) is treated in the manner provided in section 1368(c)(2) and (3).

Table 3, below, provides an overview of the differences in tax treatment of distributions of various entities.

Table 3 <u>Tax Treatment of Profits and Losses of Various Entities</u>

ISSUE	C CORPORATION	S CORPORATION	DISREGARDED ENTITIES[1]
Distributions to equity owners	Ordinary income to the extent of E&P, § 301, unless treated as an exchange	Passed through to shareholders per IRC § 1368	Generally not taxed per IRC § 731
Losses	Not passed through to shareholders; must be used at corporate level to offset earnings	Passed through to shareholders per IRC § 1366(a)(1)	Passed through to partners or members per IRC §§ 702 and 704(a)
At Risk Rule	Normally applies only to closely-held corporations	Shareholders subject to at-risk rule at shareholder level	Partners and members subject to rule at the partner or member level
Passive activity loss	Applies to closely-held corporations	Applies at the shareholder level	Applies at the partner or member level
Accumulated earnings	May accumulate income for business reasons, but unreasonable accumulations subject to tax	All income is passed through to shareholders	All income is passed through to partners and members

[1] These include partnerships and limited liability companies that elect to be taxed as a partnership.

REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the course material. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions.

1. The sole proprietorship is often the best option for the single-owner in that it provides the limited liability offered by a corporation, as well as the option to avoid the double-taxation of a corporation on distributions.

   a) true
   b) false

2. Under the default rule of the Uniform Partnership Act (UPA), partners share profits:

   a) on a per capita basis
   b) in proportion to their capital contribution
   c) on whatever basis is the most advantageous for that fiscal year
   d) none of the above

3. In regards to the taxation of partnership income, a partnership distribution is not taken into account in determining the partner's distributive share of partnership income or loss.

   a) true
   b) false

4. A partner generally recognizes gain on a partnership distribution only to the extent any money included in the distribution exceeds the adjusted basis of the partner's interest in the partnership.

   a) true
   b) false

5. A partner does <u>not</u> recognize loss on a partnership distribution unless:

   a) the adjusted basis of the partner's interest in the partnership exceeds the distribution
   b) the partner's entire interest in the partnership is liquidated
   c) the distribution is in money, unrealized receivables, or inventory items
   d) all of the above must be met

6. How do members of a limited liability company split profits:

    a) they are required to split profits based on capital contributions
    b) they are allowed to split profits any way they choose
    c) they are required by most states to split profits evenly regardless of each member's capital contribution
    d) profits in an LLC must be retained and can only be split upon dissolution

7. According to ULLCA §406, a limited liability company cannot make distributions if the LLC would not be able to pay its debts as they become due in the ordinary course of business.

    a) true
    b) false

8. Do members of a limited liability company have a right to transfer their interests in the entity:

    a) generally, members of an LLC have the right to freely transfer their interest in the profits of the entity but not their interest itself without the consent of the other members
    b) all states forbid the transfer of both their interest and their right to receive profits from the entity without the written consent of all other members
    c) generally, members of an LLC can transfer their interest in the entity freely but not their right to receive the profits of the entity
    d) none of the above

9. Even if a corporation is profitable, the owners are not necessarily entitled to a dividend.

    a) true
    b) false

10. For purposes of the Internal Revenue Code, public company salaries in excess of ______ are considered "excessive" and therefore not deductible as a business expense.

    a) $100,000
    b) $250,000
    c) $750,000
    d) $1,000,000

SOLUTIONS AND SUGGESTED RESPONSES

1. A: True is incorrect. A sole proprietorship is the easiest to form, but does not provide limited liability. In addition, all profits and losses flow directly to the owner, and are taxed at the higher individual rate.

   B: False is correct. The limited liability company is the business entity form that is often the best option for the reasons stated.

   (See page 1 of the course material.)

2. **A: Correct.** According to the default rule, profits and losses are shared on a per capita basis. By agreement of the partners, another basis can be used.

   B: Incorrect. Corporate shareholders share in profits based on their capital contributions.

   C: Incorrect. The UPA default rule is to share profits on a per capita basis. By agreement, the partners may share profits and losses on another basis.

   D: Incorrect. Since one of the answers listed is correct, “none of the above” cannot be the correct answer.

   (See page 2 of the course material.)

3. **A: True is correct.** If any gain or loss from the distribution is recognized by the partner, it must be reported on his or her return for the tax year in which the distribution is received.

   B: False is incorrect. A partner’s adjusted basis in his or her partnership interest is decreased (but not below zero) by the money and adjusted basis of property distributed to the partner.

   (See pages 5 to 6 of the course material.)

4. **A: True is correct.** Any gain recognized is generally treated as capital gain from the sale of the partnership interest on the date of the distribution.

   B: False is incorrect. If partnership property is distributed to a partner, he or she generally does not recognize gain until the sale or other disposition of the property.

   (See page 6 of the course material.)

5. A: Incorrect. This is only one of three requirements that must be met. Also, the partner's entire interest in the partnership must be liquidated, and the distribution must be in money, unrealized receivables, or inventory items.

   B: Incorrect. This is only one of three requirements that must be met. The adjusted basis of the partner's interest in the partnership must exceed the distribution, and the distribution must be in money, unrealized receivables, or inventory items.

   C: Incorrect. This is only one of three requirements that must be met. The adjusted basis of the partner's interest in the partnership must exceed the distribution, and the partner's entire interest in the partnership must be liquidated.

   D: Correct. All of the three requirements must be met.

   (See page 7 of the course material.)

6. A: Incorrect. There is no such requirement. Members may fashion whatever formula they wish for distribution of profits.

   B: Correct. Generally speaking, members of an LLC can devise any plan they wish for distribution of profits.

   C: Incorrect. There is no such requirement.

   D: Incorrect. There is no such requirement.

   (See page 14 of the course material.)

7. **A: True is correct.** An LLC also may not make distributions if the company's total assets would be less than the sum of its total liabilities plus the amount that would be needed if the company were to be dissolved, wound up, and terminated at the time of the distribution to satisfy the preferential rights.

   B: False is incorrect. ULLCA §406 also provides the methods that can be used to determine financial insolvency, stating that the company can base its findings "on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances or on a fair valuation or other method that is reasonable in the circumstances."

   (See page 15 of the course material.)

8. **A: Correct.** Members can generally freely transfer their right to the profits of the entity but are typically precluded from transferring their actual ownership interest without the consent of the other members unless their operating agreement provides otherwise.

   B: Incorrect. This is not the case with either the right to receive profits or the member's interest in the entity.

   C: Incorrect. Just the opposite is true. Other members have more of a say in who the owners of the entity are than who has a right to profits.

   D: Incorrect. Because A is true, this cannot be correct.

   (See page 20 of the course material.)

9. **A: True is correct.** The general rule of law is that shareholders are not entitled to a dividend. The discretion to grant a dividend lies solely with the corporation's Board of Directors.

   B: False is incorrect. Only in a few very limited situations, normally involving closely-held corporations, have shareholders been successful in compelling dividends.

   (See page 25 of the course material.)

10. A: Incorrect. The actual amount is much higher.

    B: Incorrect. The actual amount is much higher.

    C: Incorrect. The actual amount is much higher.

    D: Correct. Publicly traded companies may not deduct as a business expense salaries in excess of $1,000,000 as those are considered "excessive" pursuant to the Internal Revenue Code.

    (See page 26 of the course material.)

Glossary

Corporation – A legal entity that has rights usually only reserved for individuals. The primary advantage of a corporation is that it provides its shareholders with a right to participate in the profits without any personal liability.

Dissolution – The act of ending, terminating or winding-up a company. For example, when the life of a company is ended by normal legal means, it is said to be dissolved.

Distribution – Payments made to members, partners, or shareholders. May include dividends from earnings, capital gains from sale of portfolio holdings and return of capital.

General Partnership – A partnership in which each general partner shares in the administration, profits and losses of the operation. It is composed of two or more general partners. No formal registration is required with the state.

Limited Liability Company – A legal entity that has the option of being taxed like a partnership, but shields personal assets from business debt like a corporation.

Limited Liability Partnership – All of the partners are normally entitled to limited liability status for the acts or omissions of the partnership, though generally not for his or her own acts or omissions. Many states reserve this form of entity for certain professional associations.

Limited Partnership – A partnership that is a business arrangement whereby the operation is administered by one or more general partners and funded by limited or silent partners who are legally responsible for losses based on the amount of their investment.

Partnership – A partnership is a business entity in which two or more individuals carry on a continuing business for profit as co-owners. Legally, a partnership is regarded as a group of individuals rather than as a single entity, although each of the partners file their share of the profits on their individual tax returns.

S Corporation – A special type of corporation in which shareholders receive the benefits of pass through taxation generally available to partnerships while still maintaining limited liability. A number of requirements limit the type of entities eligible for this type of federal tax treatment.

Sole Proprietorship – A business owned and operated by one person. The business has no legal existence separate from that of the owner.

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