Tax Distributions for Pass-Through Entity Owners

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Tax distributions provided for in a shareholder agreement of an S Corporation or in an operating agreement or partnership agreement of an entity taxed as a partnership are both common and prudent.

S Corporations and entities taxed as partnerships are "pass-throughs" for federal income tax purposes. All income or loss recognized by the entity is passed through to the owners and taxed directly on the income tax returns of the owners. Even though income of the pass-through entity is taxable to its owners, without a tax distribution provision, owners may have to use their own cash rather than cash provided by the entity to pay the tax. This article addresses considerations to take into account in negotiating a tax distribution provision.

S Corporations

S Corporations are limited to having a single class of stock, and only differences in voting rights are permitted. No special allocations can be made, and all distributions, including tax distributions, must be made proportionately among shareholders based upon share ownership.

A typical tax distribution provision in a shareholder agreement of an S Corporation would apply a tax rate to the income of the S Corporation. As is discussed in more detail below, one issue to consider is whether the tax distribution should be based on annual taxable income or cumulative income from the time the corporation started, or maybe from the time the shareholder agreement was entered. The product of the tax rate and income is the amount of annual tax distribution.

If the entity has loans outstanding, a tax distribution provision should be included in all loan documents to make sure that such distributions are allowed.

The major caveat for an S Corporation tax distribution provision is that owners may face different tax rates. For federal tax purposes,

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some owners may be in higher tax brackets than others. Also, owners may reside in different states and have varying state and local income tax rates applicable to S Corporations allocated to them. In addition, some states may require an S Corporation to withhold taxes or pay taxes for some shareholders but not others.

The Treasury Regulations for S Corporations acknowledge that state tax laws may impose withholding or tax payment requirements on income allocated to some owners, e.g., nonresidents, but not on others. The Regulations provide that such laws are disregarded in applying the single-class-of-stock rule provided the constructive distributions resulting from the payment or withholding of taxes by the corporation are taken into account when distributions are made to other shareholders. A difference in timing between the constructive distributions and the actual distributions to the other shareholders does not cause the corporation to be treated as having more than one class of stock.[1]

Partnerships

For entities taxed as a partnership, the premise for tax distributions is the same as that used for S corporations; namely, the entity will distribute cash to owners each year sufficient to allow them to pay taxes attributable to income allocated to them. No single tax distribution provision works for all owners in all situations. Each case will depend on its own fact and circumstances when determining what tax distribution language works best for the respective owners. Here are three important considerations to take into account.

1. What Is the "Income" of the Partnership?

(a) What is meant by "income" in the context of a partnership is not always free from doubt. As alluded to in the case of an S Corporation, an initial question is whether the income on which a tax distribution is based should be the income for that particular year or income calculated on a cumulative basis such that prior year losses might offset income in the current year. Under the latter approach, tax distributions would not be made until the entity is in a net profit position over all years taken into account.

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The determination is important because requiring a company to make a tax distribution could be a serious drain on cash flow if the company has profits in a particular year but is in a loss position for all years. Beyond that, some owners may have already used losses allocated to them in prior years to offset other income. Those losses obviously cannot offset company income for the current year. In such a case, those owners would have to use their own funds if tax distributions were based on income calculated on a cumulative basis instead of a year-to-year basis. On the other hand, even if income were calculated on an annual basis rather than a cumulative basis, many owners would not have been in a position to use prior-year losses allocated to them by the entity due to the passive activity loss or the at-risk rules. When the entity does provide income to those owners, the losses suspended in prior years could be used to offset income of the entity, which may make a tax distribution unnecessary.

(b) Another important consideration for entities taxed as a partnership is the concept of "income" itself is not completely clear. The Treasury Regulations under Section 704(b) require capital accounts for entities taxed as partnerships to be determined with reference to "book income." The calculations are not made with reference to taxable income. The main difference between book and tax income is that book income calculates depreciation along with gain and loss on the sale of property with reference to the value at which the property was credited for capital account purposes when it was contributed to the company. Differences between book and tax income can also arise when cash is contributed to a company upon the admission of a new member and the capital accounts of the other members are booked up (or down) to reflect the value of the assets of the company at the time the new member is admitted. In either of those scenarios, there will be discrepancy between the basis of assets for book purposes and the basis for tax purposes.

For tax purposes, the rules of Section 704(c) of the Internal Revenue Code require taxable income, not book income, to be determined and allocated in a manner that takes into account the difference between the book basis and tax basis of assets. The issue to consider for a distribution provision is whether tax distributions are

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based upon book income or income that takes into account Section 704(c) adjustments.

Also, in some circumstances, there may be owners who are entitled to special basis adjustments due to the rules of Section 743(b) of the Code in the context of entities that have made an election under Section 754 of the Code to adjust the basis of assets when an interest in the entity is sold or exchanged or when an owner dies. Another question in the calculation of income for tax distribution purposes is whether Section 743(b) adjustments need to be taken into account in determining a particular partner's or member's income.

2. Tax Rate

Another consideration, as discussed above for S corporations, is what is the appropriate tax rate to apply to income once the income has been determined? One approach is to use a fixed rate that would take into account the highest federal, state and local tax rates for the owners. The issue to consider is what if some owners are in states with higher income tax rates than others? Is the rate of tax going to be based upon the owner with the highest state tax rate even though several owners may pay a lower state tax rate? Alternatively, is a larger tax distribution to be made to owners with higher state taxes? A further consideration is whether self-employment taxes should be taken into account along with income taxes. The question is an important one and, depending on the circumstances, you may want larger distributions made to reflect self-employment taxes or higher state taxes, or you may not want that to occur.

3. Economic Impact

For entities taxed as partnerships, varying distributions can be made among the members. There is no single-class-of-stock requirement as there is for an S Corporation. Disproportionate distributions to members are permitted to cover their differing tax liabilities. The question to address is how are those distributions treated for economic purposes? Typically, a tax distribution will be

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treated as an offset to other distributions an owner is entitled to receive. The offset might be made against other annual distributions the owner is entitled to, or the offset might be delayed until the entity terminates. The issue comes down to timing, but timing of the offset can be an important economic consideration. Alternatively, a disproportionate tax distribution might be treated as a loan on which an interest rate might be charged.

Takeaways

Tax distributions are important for pass-through entities and should be carefully considered and negotiated. The main point to take away from this article is that there is no single correct tax distribution provision. The appropriate wording will be a function of determining what works best for the entity and its owners.

Contact the author, Martin Mooney, if you have questions regarding which tax distribution provisions are most conducive to your entity and/or ownership structure. You can also visit Frost Brown Todd's Tax law Defined® Blog to read about the latest in federal, state, and local tax administration and tax-saving techniques.

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[1] See Treas. Reg. §1.1361-1(l)(2)(i) and (vi) example 6.

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