DON'T TREAT S CORPORATION DISTRIBUTIONS LIKE PARTNERSHIP DRAWS

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DON'T TREAT S CORPORATION DISTRIBUTIONS LIKE PARTNERSHIP DRAWS[1]

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1. Summary

- Uncertainty about S corporation status is not tolerable.

- Distributions to S corporation shareholders must be treated with much more formality than partner draws from a partnership.

- Failing to respect these formalities can have two terrible consequences:

  ⇒ The corporation could become a C corporation for tax purposes -- a *tax* disaster.

  ⇒ The shareholders could become liable for judgments against the corporation -- a *financial* disaster.

- Accountants must evaluate each year whether the corporation continues to be an S corporation. By filing Forms 1120S and 100S for a year, the accountant is effectively telling the client "I determined that this corporation was an S corporation for that year."

- Attorneys who prepare minutes for S corporations are in an excellent position to minimize these risks for their clients.

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[1] *This outline should be viewed only as a summary of the law and not as a substitute for tax or legal consultation in a particular case. Your comments and questions are always welcome.*

2. Background

2.1. Closely-Held C Corporations

- When a C corporation makes a dividend, the profit is taxed twice – once when the corporation earns it and pays its tax on it, and again when the shareholder receives the dividend and pays tax on the dividend.[2]

- The rate of federal tax on dividends paid to individuals is low.[3]

- Nevertheless, closely-held C corporations seldom pay dividends -- and their advisors seldom deal with the mechanics of corporate dividends.

2.2. "Draws"

- Distributions to partners are often called "draws."[4]

- The partners who are active in the partnership business might take regular draws rather than salaries.[5] The partnership might also make other distributions as cash flow permits.

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[2] I.R.C. §§ 11, 301.

[3] I.R.C. § 1(h).

[4] The Income Tax Regulations define a "draw" as an advance against a future distribution, but in this outline "draw" is used in the colloquial sense to refer to routine non-liquidating distributions from the entity. See Treas. Reg. § 1.731-1(a)(1)(ii); W. McKee, R. Nelson & R. Whitmire, FEDERAL TAXATION OF PARTNERSHIPS & PARTNERS at ¶ 19.03[2].

[5] The IRS takes the position that a partner cannot receive "wages" from the partnership. Treas. Reg. § 1.707-1(c); Rev. Rul. 69-184, 1969-1 C.B. 256; *see* S. Klig & E. Sloan, PARTNERSHIPS – TAXABLE INCOME, ALLOCATION OF DISTRIBUTIONS, Tax Mgmt. Port. (BNA) at VI.D.2.b.

- If the partnership makes distributions that are not proportionate to the partners' percentage interests in the partnership, the partnership *either* can make equalizing distributions *or* just wait until dissolution.

  ⇒ If the partnership agreement provides that liquidating distributions must be made according to positive capital accounts, and the liquidating distributions are made that way, then any disproportionate distributions will be "equalized" when the liquidating distributions are made.[6]

- These general rules apply to all entities classified as partnerships for partnerships for tax purposes (general partnerships, limited partnerships and limited liability companies).

- It is not likely that making informal distributions will increase the risk that the partners of "real" partnership (general and limited partnerships) will be held liable for its debts.

  ⇒ However, members of limited liability companies can be liable for claims against the LLC if the "corporate veil" is "pierced."

- A partnership cannot inadvertently become a C corporation.[7]

- Although both partnerships and S corporations can make tax-free distributions, several rules regarding distributions are *dramatically different* for S corporations.

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[6] Treas. Reg. § 1.704-1(b)(2)(iv)(b) (general capital account rules).

[7] To be classified as a corporation for tax purposes, the partners must make an affirmative election to be taxed that way. *See* my outline *S Corporations: The Nuts and Bolts*.

2.3. **Tax-Free Distributions by S Corporations**

- For a client who is stuck with a corporation (as opposed to an LLC classified as a partnership for income tax purposes) one of the great things about an S corporation is that it can pay tax-free dividends to shareholders.[8]

- However, tax laws limit the amount that an S corporation can distribute tax-free. Basically it is the amount of the corporation's taxable income in all S corporation years, less S corporation losses and prior distributions.[9] Distributions beyond this limit are *taxable* distributions of C corporation profit (if there are any C corporation profits that were not already distributed), then tax-free return of basis in the shares, then capital gain.[10]

  ⇒ Accountants usually monitor this.

  ⇒ Attorneys can check the balance sheet to see if distributions cause the company's retained earnings to drop below the last C corporation year's level; if so, be sure that the client and accountant are aware of the limits on tax-free dividends by S corporations.

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8 *See* my outline *C2S: The S Corporation Election for an Existing C Corporation*.

9 I.R.C. § 1368. *See* 6.1 below. *See also* my outline *S Corporations: The Nuts and Bolts*.

10 *Id.* Special rules apply when an S corporation makes distributions and then in the same year has losses that wipe out its accumulated S corporation profit. Other special rules apply when the S corporation has tax-free income or expenses associated with such income.

- S corp distributions that are not included in gross income are not subject to the 3.8% tax on investment income.[11]

- Also, if an S corporation distributes to its shareholders property with a current market value that exceeds the tax basis of the property, the shareholders will pay tax on the excess.[12]

2.4. Single Level of Tax on Distributed Profits + Favorable Tax Rates

- Another great thing about an S corporation is that when it sells its business in an asset sale,[13] the sale will have *one* level of tax, often with most of that tax at the *favorable* long-term capital gain rates for individuals – an approximate combined California and federal tax rate of 35%.[14]

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[11] I.R.C. § 1411. The pass-through income is subject to the tax, if the shareholder does not materially participate in the corporation's business.

[12] I.R.C. §§ 311(b), 1366. This could trigger corporate-level "built-in gain" tax under I.R.C. § 1374. *See* my outline *C2S: The S Corporation Election for an Existing C Corporation*.

[13] Buyers generally want to buy the assets -- not the stock -- of a closely-held corporation. *See* my outline *Selling the Business: Practical, Tax and Legal Issues*.

[14] Federal rate of 20% + California rate of 13.3% (for income over $1 million) + California S corporation tax rate of 1.5%. This assumes that the S corporation is not subject to the built-in gains tax and that most of its gain is capital gain. For California tax purposes, the taxable income is subject to a 1.5% tax paid by the S corporation. Cal. Rev. & Tax. Code § 23802(b)(1). Each shareholder may deduct his or her share of this California tax for federal tax purposes. I.R.C. §§ 164(a)(3), 1366. These rate estimates do not take into account the effect of the federal 3% and California 6% itemized deduction cut-backs, which have the effect of increasing the effective tax rates. This rate estimate also assumes that the seller is active in the business of the S corporation; otherwise, the federal 3.8% tax on investment income would also apply to the pass-though income. I.R.C. § 1411.

- ⇒ In contrast, when a C corporation sells its business in an asset sale, there are *two* levels of tax, the combined tax rate is 64%.[15]

- ⇒ For a company that sells its assets for $50M or more with virtually no basis in the assets, the difference can be more than $10M (~$18M as an S corporation vs. ~$28M as a C corporation).

- For estates and trusts in the highest federal tax bracket, the flow-through income is also subject to the 3.8% tax on investment income.[16]

- For individual shareholders who are not active in the business, the flow-through income from passive investment activities of the S corporation is subject to the 3.8% tax on investment income.[17]

- Tax-free distributions and selling the business with one level of tax are usually the big reasons to take steps to preserve the S corporation status.[18]

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[15] Combined effective federal and California corporate tax rate of 40% plus a combined effective personal capital gain rate of 35% (plus the 3.8% tax on net investment income) on the 60% of the gain distributed to the shareholders = 40% + (60% x (35%+ 3.8%) = 64%. The 35% rate estimate is subject to the caveats in the preceding footnote. The effective corporate rate would be 41% if the corporation's taxable income exceeded $10M or the top federal corporate rate applied for any other reason.

[16] I.R.C. § 1411(a)(2).

[17] I.R.C. § 1411.

[18] Other reasons to prefer S corp (vs. C corp) status might be avoiding the accumulated earnings or personal holding company penalty taxes, or avoiding "unreasonably high compensation" problems. *See* my outline *C2S: The S Corporation Election for an Existing C Corporation*.

2.5. You Just Gotta Know

- Some tax issues invite aggressive positions when the downside is manageable.

- Qualifying as an S corporation is *not* one of those issues.

  ⇒ When it comes time to pay a dividend, to sell the corporation's assets or to make a Section 338(h)(10) election to accommodate a buyer of the corporation's stock, it is *critical* to know whether or not the corporation is an S corporation.

- For this reason, it is best to be *very conservative* about S corporation qualification.

3. Dividend Decisions Affect Shareholder Liability

3.1. The Corporate Law Framework

- A corporation is governed by its Board of Directors, which is responsible for deciding when and in what amounts dividends will be paid.

- The dividend is expressed in *dollars per share* payable on shares of a specific *class of shares.*

- The Board also specifies the *"record date"* for the dividend.[19] Generally, shareholders of record (on the corporation's books) as of the record date receive the dividend. Shareholders who sell shares before the close of business on that date do not receive the dividend for those shares.[20] The purpose of the record date is to allow the market to

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[19] Cal. Corp. Code § 701.

[20] Cal. Corp. Code § 701(d).

digest the effect of the right to the dividend on the price of the shares. The record date is never earlier than the date of the Board meeting.

- In addition, the Board sets the *payment date* for the dividend, which must be within 60 days after the date that the Board declares the dividend.[21]

3.2. The Public Company Model

- In the public company model, the chief financial officer reports to the Board that the corporation has more cash than it can profitably deploy in the corporation's business, and suggests that the Board consider paying a dividend to the shareholders. After reviewing the financial reports provided by the CFO, the Board might declare a dividend.[22]

- Public companies rarely declare dividends more frequently than quarterly.

3.3. Corporate Formalities and "Piercing the Corporate Veil"

- When an S corporation declares dividends, it should respect the corporate law framework and should not depart too far from the public company model for dividends.

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[21] Cal. Corp. Code § 701(a). For a dividend payable immediately, the record date is the date of the directors meeting or action. Cal. Corp. Code § 701(b)(3).

[22] When shares are listed on an exchange, the exchange sets an *"ex-dividend" date*, which is usually five days before the record date. The seller of shares sold "ex-dividend" gets the dividend, even if the buyer becomes the shareholder of record before the record date. The "ex-dividend" rules address two realities of the stock market: (1) it takes an unpredictable amount of time to process a sale, but (2) a buyer and seller need to know with certainty which of them will receive the dividend. 2-8 Ballantine & Sterling, CALIFORNIA CORPORATION LAWS, § 142.05[4][b][iv].

- ⇒ The risk is that failing to adhere to basic corporate formalities will be a factor that will influence a judge or arbitrator to "pierce the corporate veil" and to hold the *shareholders* liable for a judgment against the *corporation*.[23]

- To minimize this risk, it is important for S corporations to have the Board of Directors authorize *each* and *every* distribution to shareholders.[24]

  - ⇒ The Board should express the dividend as a specific dollar amount per share.

  - ⇒ The Board should set both a record date (typically the date of the Board's action) and a payment date (typically "payable immediately") for each dividend.

- To make correct distributions, the officers must know the number of shares held by each shareholder.

  - ⇒ For some companies it is a challenge to determine the exact number of shares outstanding.[25]

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[23] *See generally* B. Witkin, SUMMARY OF CALIFORNIA LAW, XIII (Corporations) at I.C., § 9 *et seq.* Is this a "real life" issue or just legal theory? A quick LEXIS search on 10-19-05 showed 94 appellate cases addressed this issue in the last five years in California state courts alone. This does not include cases that ended before an appellate decision, or were appealed and not published. Nor does it include any federal court or bankruptcy court cases. It's a real issue.

[24] The Board may delegate to a committee of at least two directors the authority to approve distributions in specific amounts or within a specified range. However, for most closely-held businesses it is less hassle to have the Board approve each distribution.

The Board should *not* delegate to officers decisions about distributions. The Board should *not* ratify past officer decisions to make (or not make) distributions.

⇒ Usually any uncertainties are resolved when the S corporation election is made, because the federal election form requires a list of the number of shares held by each shareholder.[26]

⇒ To protect the valuable S corporation status and to respect the corporate formalities and avoid piercing the corporate veil, the corporation's stock records must be in order.[27]

- This also applies to dividends declared by C corporations.

3.4. Corporate Law Limits on Distributions

- There are corporate law limits on the amount that a corporation can distribute. These limits protect the corporation's creditors.

- For financial accounting purposes, cash distributions reduce both cash (on the asset side of the balance sheet) and retained earnings (on the equity side of the balance sheet).

(footnote continued from prior page)

[25] The corporation's attorney should help the corporation develop accurate stock records.

[26] Form 2553, Election by Small Business Corporation. In the alternative, the shareholders may list their relative percentages of ownership, which is not the best practice. They must also list the dates on which they acquired the shares.

[27] Note also that there is *no title insurance for stock*, so if bad stock records result in litigation, the shareholders will not have insurance to pay any of the legal fees to straighten out the mess.

⇒ Basically, the corporation can't distribute so much cash that its retained earnings fall below zero.[28]

⇒ Creditors can recover excess distributions from the *recipients* and, possibly, from the *directors* who authorized the improper distributions.[29]

- For an S corporation that only makes tax-free distributions of S corporation profits to all of its shareholders, these corporate law limits will rarely apply.

  ⇒ However, they are very likely to apply if the corporation *buys out a shareholder*, whether for cash or for a promissory note.[30]

4. **Distributions and Salary**

- Many S corporation shareholders hope to reduce the 2.9% federal Medicare tax[31] on wages by reducing their salaries and bonus-

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[28] Cal. Corp. Code § 500(a). There is an alternate test comparing total assets to total liabilities, and current assets to current liabilities. Cal. Corp. Code § 500(b). *See also* Cal. Corp. Code §§ 114 (requiring the use of GAAP), 166 (defining "distribution to shareholders") and 501 (insolvency) and, generally, Chapter 5 of the General Corporation Law.

[29] Cal. Corp. Code §§ 316(a)(1) (recovery from directors), 506 (recovery from shareholders). Directors who approve an unlawful distribution can also be guilty of a misdemeanor. Cal. Corp. Code § 2253. Creditors might also recover under the Uniform Fraudulent Transfer Act. Cal Corp. Code § 506(d).

[30] See generally 2-8 Ballantine & Sterling, CALIFORNIA CORPORATION LAW § 143. Consider having shareholders purchase the stock instead of the corporation. Doing so also avoids the "disappearing basis" problem: When the corporation buys the shares, the tax basis of the shareholders in their retained shares does not increase, but if the shareholders buy the shares, their tax basis increases by the purchase price.

[31] I.R.C. §§ 3101(b)(6) (employee portion), 3111(b)(6) (employer portion).

es and increasing dividends.[32] The rate is 3.8% on wage income over $250,000.

⇒ In contrast to its position on partnerships, the IRS takes the position that shareholders who work full-time in the S corporation's business cannot take all of their cash from the business as tax-free distributions – some reasonable portion of that cash must be characterized as wages subject to withholding and employment taxes.[33]

⇒ The IRS has successfully asserted in several cases that zero salary is unreasonably low for a shareholder who devotes his or her full time to the S corporation's business.[34]

- In view of the IRS position, all shareholders who are full- or part-time employees of the S corporation should take a reasonable salary.[35]

  ⇒ Shareholders who receive several hundred thousand dollars in dividends from the corporation should not receive an unreasonably low salary (probably not less than the FICA maximum, although there is no magic to that number and neither the IRS nor any court has pegged it as safe).[36]

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[32] I.R.C. §§ 1401(b) (Medicare tax on "self-employment income") 1402(a)(2) (dividends excluded from definition of "self-employment income").

[33] Rev. Rul. 74-44, 1974-1 C.B. 287.

[34] *See* J. Eustice & J. Kuntz, FEDERAL INCOME TAXATION OF S CORPORATIONS at ¶ 11.02[5][c].

[35] *See* my outline *S Corporation Update: Adequate Compensation*.

[36] The caps for 2009, 2008 and 2007 are $106,800, $102,000 and $97,500, respectively. I.R.C. § 3121(a)(1) (FICA cap generally), Daily Tax Report (BNA) 201 DTR G-1, October 17, 2008 (FICA cap for 2009), Notice 2007-92, 2007-

(footnote continued on next page)

- Shareholders who received compensation of several hundred thousand dollars annually when the corporation was a C corporation should consider gradually reducing their compensation over several S corporation years.

  ⇒ Decelerating too fast might provide evidence that (1) the compensation in the C corporation years was unreasonably high and should be treated as part compensation and part taxable dividend and/or (2) the compensation in the S corporation years is unreasonably low and should be subject to the Medicare tax as wages.

- S corporation profits are subject to a California tax of 1.5% corporate-level tax on taxable income which is deductible by the shareholders for federal but not California purposes.[37]

  ⇒ The net effect is to reduce (but not to eliminate) the tax benefit of distributions over salary.

5. Protecting the S Corporation Status

5.1. One Class of Stock

- To be eligible to make the S corporation election and to retain S corporation status, all classes of its outstanding stock must participate equally in dividend distributions and liquidating distributions.[38]

(footnote continued from prior page)
47 I.R.B. 1036 (FICA cap for 2008), Notice 2006-102, I.R.B. 2006-49 (FICA cap for 2007).

[37] See footnote 14 above.

[38] I.R.C. §§ 1361(a)(1) definition of S corporation), (b)(1)(d) (one-class-of-stock rule), (c)(4) (differences in voting rights permitted), (1362(a)(1) (election), (d)(2) (termination of S corporation status by ceasing to be an eligible corporation); Treas. Reg. § 1.1361-1(*l*)(1) (the one-class-of-stock regs).

⇒ In other words, in *every* distribution or dividend by an S corporation, each *share* must receive the *same number of dollars*.

⇒ When one shareholder gets a distribution of $100 per share and another gets a distribution of $150 per share, they are *not* participating equally in dividends.

⇒ If the circumstances indicates that a binding agreement requires these differences, the S corporation status could be terminated.[39]

5.2. Treating S Corporation Distributions Like Partnership Draws

- Sometimes officers of S corporations treat dividends like partnership "draws," paying dividends according to need and not strictly according to the number of shares owned.

  ⇒ This is a particular problem in family-owned businesses.

- The "draw" approach risks making the corporation ineligible to be an S corporation, which invites a double income tax (to both the corporation and the shareholders) when the dividends are paid *and again* when the business is sold.[40]

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39 Treas. Reg. § 1. 1361-1(*l*)(2)(vi) *Example 2*.

40 Even if the distributions are eventually "equalized" so that there is only a timing difference, the Income Tax Regulations might require this timing difference be treated as a loan subject to *imputed interest*, with the unpaid interest possibly treated as a *gift* or *compensation*. *Id.*

- When gathering information to prepare minutes for S corporations, attorneys should ask for a list of all distributions made during the year.

  ⇒ The list should show the date, amount and recipient of each distribution.[41]

  ⇒ The board of directors should approve in writing *every distribution* in advance, specifying the record date, the method of payment and the number of dollars per share to be distributed.

  ⇒ Distributions should *not* be declared or paid more often than quarterly.

5.3. The Kinder, Gentler IRS – in 1992

- In 1990 the IRS proposed that constructive dividends and disproportionate distributions would indicate more than one class of stock and would automatically terminate the S corporation status.

  ⇒ The IRS proposal triggered a "firestorm" of negative comments from business owners, accountants and attorneys. Congressional committees threatened to change the IRS position by legislation if the IRS formally adopted its proposal.[42]

- The IRS backed off in 1991 and said in final regulations (adopted in 1992) that disproportionate distributions will *not* automatically indicate a second class of stock, as long

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[41] The attorney should spot check to assure that distributions are made strictly according to shareholdings.

[42] See J. Eustice & J. Kuntz, FEDERAL INCOME TAXATION OF S CORPORATIONS at ¶ 3.08[1].

as the disproportionate distributions are not required by a binding agreement.[43]

⇒ Implicit is the requirement that equalizing distributions are paid within a reasonable time.[44]

- The lesson: Taxpayers should not expect the IRS to ignore disproportionate distributions by S corporations.

⇒ The issue has received a lot of attention in the recent past.

⇒ The IRS has shown that it cares about this issue.

- To protect the valuable S corporation status, be *scrupulous* about making distributions in *exact proportion* to share ownership.

5.4. Classes of Shares with Different Voting Rights

- An S corporation is permitted to have classes or series of stock with different *voting rights*, as long as the rights to dividends and liquidating distributions are *exactly the same* for each class or series.[45]

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[43] T.D. 8419, 1992-2 C.B. 217.

[44] Treas. Reg. § 1. 1361-1(*l*)(2)(vi) *Example 2*. The distributions were equalized *in the next year* in the example in the regulation. *Note*: The 1990 proposed regulations required the equalizing distribution in the *same taxable year* as the disproportionate distribution or *within three months* of it. Prop. Treas. Reg. § 1.1361-1(*l*)(2)(ii)(B), -1(*l*)(5) *Example 5* (October 5, 1990), 55 FR 40870, 1990-2 C.B. 864.

[45] Treas. Reg. § 1. 1361-1(*l*)(1). It is a good practice to specifically state in the articles of incorporation that all shares will participate equally in all dividends and distributions.

- If an S corporation has classes of shares with different voting rights, it is important that the Board declare the exact same dividend per share to each class of shares at exactly the same time.

  ⇒ The record date and payment date should be exactly the same for each class.

5.5. **Distributions to Pay Estimated Taxes**

- Shareholders of S corporations must pay quarterly estimated federal and state taxes on their shares of the S corporation's income.

  ⇒ Sometimes they expect the corporation to distribute to them the amount that they will need to pay these taxes.

- The shareholders might not all have the same tax rates, or the parents might be happy to leave the cash for their taxes in the corporation, where it will eventually benefit their descendants who hold shareholders.[46]

- If the distribution policy can be specifically enforced by a shareholder in court, the disproportionate distributions are subject to a binding agreement.

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[46] The amount of estimated tax that each shareholder must pay depends on his or her tax rate and the losses that the shareholder expects from other sources for the year. The amount of state tax also depends on the state in which the shareholder resides.

Some distributions might be a tax-free return of basis for one taxpayer and taxable to another shareholder as long-term capital gain. I.R.C. § 1368.

⇒ This is a common way that S corporations violate the "same-number-of-dollars-per-share" rule.[47]

- The S corporation can pay dividends to its shareholders at times and in amounts that will allow the shareholders to pay their estimated tax obligations -- if it distributes the "same-number-of-dollars-per-share" at the *same time* to *all* shareholders.

⇒ However, the S corporation should *not* pay directly to a tax agency the estimated taxes of any shareholder.

⇒ Unless there is an equalizing cash dividend paid at the same time, this might violate the "same-number-of-dollars-per-share" rule.

⇒ Also, having the corporation pay personal obligations of the shareholders might influence a judge or arbitrator to "pierce the corporate veil."[48]

⇒ Finally, it is less likely that the Board will formally declare the dividend when the payment is not made directly to the shareholders.

⇒ It is much better to make cash distributions to the shareholders (in exact proportion to their shareholdings) and to let them pay their own estimated taxes.

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[47] Treas. Reg. § 1.1361-1(*l*)(2)(vi) *Example 6*. Although the 1992 one-class-of-stock regs were generally much more forgiving of mistakes, in this example the IRS *did not* soften its position. *Cf.* Prop. Treas. Reg. § 1.1361-1(*l*)(5) *Example 4* (October 5, 1990), 55 FR 40870, 1990-2 C.B. 864.

[48] See footnote 23 above.

⇒ This can be the subject of a shareholders' agreement, or addressed in a buy-sell agreement designed to protect the fragile S corporation status.

- *Note*: There is no corporate or tax law requirement that an S corporation make distributions in amounts sufficient to enable the shareholders to pay their estimated taxes on the S corporation's income.

- Unless there is an agreement about this, it is *entirely* up to the board of directors if, when and in what amounts the corporation will distribute cash to its shareholders.[49]

5.6. Fixing Bad Distributions

- Sometimes an S corporation has made distributions that are not proportionate to the shareholdings at the time of each distribution.

- To protect its S corporation status, it is important to make "equalizing" distributions as soon as possible.

  ⇒ In the final "one class of stock" regulations, the IRS blessed this method of protecting in the S corporation status.[50]

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[49] A buy-sell agreement or a shareholders agreement for an S corporation can address this. *See* my outline *Buy-Sell Agreements for Closely-Held Businesses: An Overview*.

[50] Treas. Reg. § 1. 1361-1(*l*)(2)(vi) *Example 2*. The Supplementary Information to the final 1992 regs stated:

> Comments also requested guidance on the appropriate tax effects of distributions that differ in timing or amount. Because the tax effects of such distributions are necessarily based on other provisions of the Code, general tax law

(footnote continued on next page)

- What might *not* work:

  ⇒ In this situation it often is tempting to treat some of the payments as loans from the corporation to a shareholder. If, however, there is no contemporaneous evidence that a payment was a loan, or was part loan and part distribution, it is probably best to treat it all as a distribution. (This is particularly true when the payment occurred in a prior period and the balance sheet as of the last day of the period did not show the amount as a loan to the shareholder.)

  ⇒ Similarly, it is sometimes tempting to assert that one shareholder received a dividend payment that should have been paid to another shareholder, so the shareholders should account to each other for the disproportionate parts of the dividends. However, the IRS regulations do not bless this approach and it would leave the key evidence (the checks from one shareholder to another) in the hands of specific shareholders, and not in the hands of the corporation, which probably will be the subject of the audit if the issue arises.[51]

- What we know *does* work: The best approach is to have the corporation pay *additional* dividends to assure that the same number of dollars per share were paid to all share-

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(footnote continued from prior page)

principles, and the particular facts and circumstances, the final regulations do not provide additional guidance on this issue.

T.D. 8419, 1992-2 C.B. 217.

[51] The owners of the shares when the audit issue arises might not be the same people who swapped checks to equalize the distributions.

holders for each distribution. This is the only correctional method blessed by the regulations.[52] Here are the steps:

⇒ For each distribution, determine the actual distribution per share in dollars to each shareholder (treating all distribution payments made within a few days as one distribution).

⇒ For that distribution, identify the shareholder(s) who received the highest distribution per share.

⇒ Calculate what the distribution would have been for each other shareholder at that highest amount per share.

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[52] The IRS has issued several private letter rulings on equalizing distributions. PLR 2008-02-002, September 28, 2007 ("corrective distributions" made by S corporation); PLR 2008-07-004, November 9, 2007 (excess compensation partially paid back to S corporation; corrective distributions made to other shareholders; "to the extent … [the] S corporation election terminated due to the excess additional bonus compensation paid by the Company…, any termination was inadvertent…."); PLR 2007-30-009, April 25, 2007 (both corrective distributions and repayments to S corporation allowed to equalize); PLR 2007-09-004, November 9, 2006 (shareholders agreement changed corporate law rules regarding distributions following stock ownership, allowed distributions to track former stock ownership; did not create second class of stock); PLR 2005-24-020, February 6, 2005 (payments to tax authorities directly by S corporation were disproportionate to stock ownership; corrective distributions avoided second class of stock); PLR 2003-05-021, October 25, 2002 (S corporation makes remedial distributions and pays interest); PLR 2002-26-009, March 18, 2002 (difference in timing; remedial distributions); PLR 2000-28-026, April 18, 2000 (transfers of S corporation stock to trusts ignored in making distributions; payments from transferees to the trusts corrected the one-class-of-stock issue); PLR 97-29-025, April 18, 1997 (disproportionate distributions to pay taxes; equalizing distributions made); PLR 95-19-049, -048, February 14, 1995 (equalizing distributions made, plus interest); PLR 95-19-036, February 14, 1995 (disproportionate distributions to pay taxes; equalizing distributions made, plus interest). Although the IRS has on occasion allowed payments from one shareholder to another, I view this as an equalizing method available *only to those who want to request a private letter ruling* – at least until we have cases blessing a shareholder-to-shareholder method of correcting disproportionate distributions.

⇒ Subtract the amount of the actual distribution to each other shareholders. The result will be a specific equalizing distribution amount for each shareholder (other than the shareholder(s) who received the highest distribution per share).

⇒ Do the above four steps for each other distribution.

⇒ Calculate the total equalizing distribution due to each shareholder for all past distributions while the S corporation election was in effect.[53]

⇒ Determine whether the equalizing distributions (i) can be paid tax-free out of S corporation profits and (ii) are permitted by the corporate distribution limitations.

⇒ Have the Board adopt resolutions authorizing the equalizing distributions.

⇒ Have the S corporation write the checks for the equalizing distributions as soon as possible.

❖ If the shareholders need to make loans back to the corporation, the shareholders should write checks to the corporation[54] and the loan should be documented with promissory notes

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[53] If the corporation ceased to qualify as an S corporation five years ago because it made disproportionate distributions that were never equalized, it is not likely that the three-year statute of limitations for most federal tax matters is going to prevent the IRS from successfully asserting that the corporation is a C corporation now.

[54] There should be checks going both ways, not just checks for the net distribution or loan.

and appropriate entries on the corporation's books.

❖ In some situations, it might be necessary to show as a liability on the corporation's balance sheet dividends declared but unpaid.[55]

6. It is Possible to Pay Tax on the S Corporation Profit -- But *Not* Get the Tax-Free Distribution

6.1. Undistributed S corporation profit has two tax consequences

- It increases the basis of the shareholder's shares, whether or not the corporation has undistributed C corporation earnings and profits; and

- If the corporation has undistributed C corporation earnings and profits, the undistributed S corporation profit also increases the corporation's "accumulated adjustment account" (or "AAA" account; yes, that's redundant).

6.2. Transfers of Shares – A Parable

- The corporate and tax law rules collide when S corporations directors want to pay dividends to people who no longer hold shares.

- Let's say Dave owns 25% of the outstanding shares of Widget Corporation, which was an S corporation for all of 2013. Dave transferred all of his shares to Jennifer on January 1, 2014.

[55] For example, if the Board authorized the equal distributions per share, but the amounts were paid disproportionately, and the equalizing distribution was not paid before the end of the period.

- On March 1, 2014 Widget Corporation pays a dividend to the shareholders of record on March 1, 2014. The dividend is intended to allow the 2013 shareholders to pay their tax on Widget Corporation's 2013 income.

- Jennifer is the shareholder of record on March 1, so Jennifer receives the dividend on her shares.

- Dave says to Jennifer "Excuse me, but that's my dividend you're holding. It is supposed to pay my tax liability for holding those shares in 2013. You, Jennifer, don't need it because you did not hold any Widget Corporation shares in 2013. In fact, the IRS regulations allow me to receive this dividend without creating a one-class-of-stock problem."[56]

- Jennifer says "Sorry, Dave. I keep the dividend. Although *tax* law *allows* it, *corporate* law *does not allow* a California corporation to declare a dividend to shareholders of record as of a date *earlier* than the date of the directors action. We did not cover this in our Stock Purchase Agreement, so I have no obligation to give my dividend to you."[57] Dave rends his garment -- and goes looking for the accountant and attorney who advised him in the stock sale.[58]

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[56] Treas. Reg. § 1.1361-1(*l*)(2)(iv).

[57] The identity of the person entitled to a dividend from a California corp can be changed "by agreement" (Cal. Corp. Code § 701(d)), but the shareholders and the S corporation should be very wary of doing so, because the agreement might create a second class of stock, terminating the S corporation status.

[58] Dave's accountant tells him that he reduced his gain on the sale of his shares by the tax basis in the shares that he would have lost if he received the distribution. Dave says "Great, I saved 35 cents on the dollar in taxes, but lost 65 cents on the dollar to Jennifer."

- Lesson: To assure that the people who pay taxes on the S corporation's income get the benefit of that income, they need either (a) to include in the price of the shares the value of the inherent right to receive tax-free distributions, or (b) to cause the S corporation to distribute immediately before any stock transaction all of the cash that the corporation can distribute tax–free.[59]

6.3. S Corporation Stock Options

- This lesson applies in option agreements to buy shares of an S corporation.

- When the option is exercised, the corporation should have a few weeks before it is required to deliver the shares.

  ⇒ This will allow the corporation to distribute to the existing shareholders all of the dividends that can receive tax-free – to the extent that the corporation has, or can raise, the cash to pay them.

7. Advisors' Duties

- Accountants who provide tax advice or prepare tax returns for the S corporation should advise the officers in writing if there is a concern about violating the one-class-of-stock rule and possibly terminating the valuable S corporation status.

  ⇒ Preparers have issues if this advice is ignored, because the preparer must decide each year whether the corporation continues to qualify to be an S corporation.

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[59] Again, if the corporation needs the cash, the shareholders can loan it back to the corporation.

- Whenever attorneys prepare minutes for S corporations, they should document all of the distributions properly and should gather the information necessary to do so.

  ⇒ They should let the client know if the corporation has been operating in a way that risks "piercing the corporate veil."

  ⇒ They should assure that every distribution is properly made and documented.

  ⇒ They should assure that the corporate records are in order and help with equalizing distributions when needed.

8. **Conclusions**

- S corporation status can be very valuable for a business that will eventually be sold for a big gain, or if the business is a cash cow.

- To preserve that valuable status, distributions must be made strictly according to shareholdings and to all shareholders at the same time.

- Disproportionate dividends paid by S corporations should be equalized as soon as possible.

- Each and every distribution should be approved in advance by the board of directors. The approval should be reflected in written minutes or a written action taken without meeting. Adhering to the corporate formalities for distributions reduces the risk of having the corporate veil pierced.

- The corporate laws that protect creditors must be considered – especially in stock redemptions.

- Whenever S corporation shares are transferred, consider whether the transferor can receive as a distribution the profits on which

the transferor has been (or will be) taxed. This requires attention when preparing stock option plans for S corporations.

[End of outline.]