



Business Entities: Distributions to Owners

Course #3103B

Taxes

2 Credit Hours

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BUSINESS ENTITIES: DISTRIBUTIONS TO OWNERS

This course covers 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.

LEARNING ASSIGNMENTS AND OBJECTIVES

As a result of studying each assignment, you should be able to meet the objectives listed below each individual assignment.

SUBJECTS

Distributions to Owners

Study the course materials from pages 1 to 47

Complete the review questions at the end of each chapter

Answer the exam questions 1 to 10

Objectives:

- Recall how profits are distributed to the owners of various entities.

NOTICE

This course is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional advice and assumes no liability whatsoever in connection with its use. Since laws are constantly changing, and are subject to differing interpretations, we urge you to do additional research and consult appropriate experts before relying on the information contained in this course to render professional advice.

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EXAM OUTLINE

- **TEST FORMAT:** The final exam for this course consists of 10 multiple-choice questions and is based specifically on the information covered in the course materials.
- **ACCESS FINAL EXAM:** Log in to your account and click Take Exam. A copy of the final exam is provided at the end of these course materials for your convenience, however you must submit your answers online to receive credit for the course.
- **LICENSE RENEWAL INFORMATION:** This course qualifies for **2** CPE hours.
- **PROCESSING:** You will receive the score for your final exam immediately after it is submitted. A score of 70% or better is required to pass.
- **CERTIFICATE OF COMPLETION:** Will be available in your account to view online or print. If you do not pass an exam, it can be retaken free of charge.

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CHAPTER 1: DISTRIBUTIONS TO OWNERS

Chapter Objective

After completing this chapter, you should be able to:

- Recall how profits are distributed to the owners of various entities.

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 or herself, 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 6.1, next:

TABLE 6.1 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 or her individual rate (but remember that sole proprietors have no liability protection)
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 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. By agreement, partners may elect to 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 §§ 603 and 604 permit 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: