

**From the desk of  
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## **S Corporation and Partnership Basis**

Many assume that the cashflow and what they distribute to themselves from their businesses is up to them, and while it is, there are definite tax consequences as to any distributions made to owners.

What is termed as “Basis” is an important concept that relates to S Corporations, Partnerships, and LLC.

Basis essentially that amount that a shareholder or partner holds in an entity which is determined by the amount originally invested into the entity, any investments, and loans to the entity thereafter, plus any accumulated profits, less losses, and of course, distributions. That mathematical formula determines for tax purposes the amount of “basis” that one holds in an entity.

To the extent that a shareholder or partner holds in an entity, distributions up to that amount is considered distribution of earnings whether current or accumulated over years. To the extent that amount has been taxed there is most instances is no further taxes incurred for distributions up to the basis one holds in an entity.

The problem comes when distributions are made in excess of basis which if not treated correctly will cause any excess distributions to be taxed at capital gains rates. To avoid additional taxation of any excess distributions one can return the excess distributions to the entity before the taxable year end, or formally enter into a loan arrangement with terms that are adhered to with a reasonable interest rate assigned to the obligation, and like with any other obligation, the terms are met and adhered to as to the borrowing agreement.

Another issue to be aware of is that if an S corporation, partnership, or LLC sustains losses in excess of a shareholder or partner's basis, that loss must be suspended as a deductible loss until such time that basis is replaced to the extent of the losses.

In a recent matter before the U.S. Tax Court, it was held that amounts withdrawn by a shareholder from his corporation's bank account were constructive dividends due to the fact that the taxpayer had failed to properly document the excess distributions as loans.

The Internal Revenue Code provides that corporate distributions to its shareholders are to be treated as dividends to the extent the distributions are paid out of earnings and profits.

A constructive dividend exists when a corporate distribution is primarily for the benefit of a shareholder, and where the expenditure(s) do not give rise to a deduction on behalf of the corporation, and the expenditures create economic gain, benefit, or income to the owner-taxpayer.

In the matter of Santos Engineering Santos Pavers, Inc. (SESP), a C corporation, Mr. Santos distributed to himself cash withdrawals amounting to \$113,846.

Mr. Santos failed to file the corporate tax returns for the year in question.

His failure to file the corporate tax returns was problematic in that the positions that could have been taken such as characterizing the distributions as loans which should have been duly authorized, documented, and a reasonable interest rate applied, with a payment arrangement entered into was a missed opportunity. Failing to do so allowed the IRS to take any position it deemed appropriate which in fact was what took place thereafter.

The IRS which provides repeated requests for tax returns prepared a substitute tax return, and then issued him a deficiency notice indicating lacking any evidence otherwise that the distributions were in fact constructive dividends which are nondeductible to the corporation, and fully taxable to the recipient, therefore the dreaded double taxation of the same income.

The Tax Court agreed with the IRS in that Mr. Santos's withdrawals from SESP's bank account constituted constructive dividends.

The Tax Court noted that, according to the bank statements produced at trial, Mr. Santos withdrew \$113,846 from SESP's bank account. Mr. Santos claimed that some of those withdrawals were used for business-related expenses and he produced \$107,476 worth of receipts to back up his claim.

Mr. Santos complicated his problem further in that the Tax Court found that the receipts Mr. Santos produced were fabricated.

The Tax Court based its finding on discrepancies in the receipts themselves and on their appearance of being prepared simultaneously.

In addition the Tax Court found that Mr. Santos's testimony regarding the receipts was vague and inconsistent.

The errors in this matter were that the taxpayer failed to compile and file his corporate tax returns thereby attracting undue attention by the IRS, and also in failing to compile and file the corporate tax returns taking a position that could have otherwise been sustainable had the appropriate work been done in advance.

**The issue is similar to what we have been seeing with a number of clients who have diverted PPP and SBA loans which were made to their S corporations, and then converted those funds for personal use.**

**The diversion is a constructive dividend, and fully taxable at the moment of conversion unless the proper documentation is in place including the minutes to the corporate books authorizing the conversion as a corporate loan to the shareholder, and the appropriate financial obligations compliant with current interest rates.**

**Those shareholder obligations need to be paid as any other loan would be, otherwise the IRS can easily classify any such conversion as a constructive dividend, and tax the distributions as such with penalties, as well as apply negligence reporting penalties, with interest assessed.**

**Essentially this is a lesson in what not to do, and when caught in that situation never attempt to solve the problem without appropriate professional assistance, or the better approach is to consult with us first before making any such transactions.**

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