Solution to Problem 2.2

"Regular" Income Tax (§§ 1, 11)

C Corporation

X owes corporate tax under Section 11, equal to 21 percent of its taxable income, or $3,150 ($15,000 × .21).

When X distributes $5,000 cash with respect to its stock to each of R, S, and T, the tax consequences to the shareholders are governed by Section 301(c). Section 301(c)(1) declares that each shareholder has gross income equal to the dividend that the shareholder receives. Section 316 defines a dividend as a distribution out of the corporation's current or accumulated earnings and profits (E&P).

X's E&P starts with its taxable income, $15,000, but is reduced by the $3,150 federal income tax owed on that income. And so X's E&P is $11,850. Because the total distribution ($15,000) is greater than that, only some of the shareholders' distributions are dividends, taxable to them as gross income (but subject to favorable capital gain rates under Section 1(h)(11)). The amount of each shareholder's dividend is $11,850 divided by 3, or $3,950. Under Section 301(c)(2), the rest of the distribution, $1,050 per shareholder ($5,000 minus the $3,950 dividend), is applied against and reduces each shareholder's stock basis. Thus, each shareholder's basis in his or her stock following the distribution is $8,950 ($10,000 minus $1,050). The corporation's accumulated E&P heading into the next year is zero. Section 312(a) reduces the E&P (but not below zero) by the amount of money distributed.

S Corporation

Assume that X has been an S corporation for its entire existence.

X is not subject to tax. IRC § 1363(a). Under Section 1366, each shareholder must report his or her pro rata share of the corporation's tax items. Thus, each shareholder has pass-through income of $5,000. It could be capital gain; the character is determined at the corporate level. Under Section 1367(a)(1), when the income passes through, the shareholder's basis in his or her stock increases by the same amount. Thus, each shareholder's stock basis increases from $10,000 to $15,000.

When the shareholders receive their $5,000 distributions, since X has never been a C corporation and thus has no accumulated earnings and profits, the tax consequences to the shareholders are governed by Section 1368(b). The distribution is not income to them, because their stock basis is greater than the amount of the distribution. Their stock basis is reduced by $5,000 each under Section 1367(a)(2) – from $15,000 each to $10,000 each.

Partnership

X is not subject to tax. IRC § 701. Under Section 702, each partner must report his or her "distributive" (economic) share of the partnership's tax items. Thus, each partner has pass-through income of $5,000. It could be capital gain; the character is determined at the partnership level. Under Section 705(a)(1)(A), when the income passes through, the shareholder's basis in

his or her partnership interest increases by the same amount. Thus, each partner's basis in their partnership interest (their "outside basis") increases from $10,000 to $15,000.

When the partners receive their $5,000 distributions, the tax consequences to them are governed by Section 731(a)(1). The distribution is not income to them, because their basis in their "outside basis" is greater than the amount of the distribution. Their "outside" basis is reduced by $5,000 each under Section 733(1) – from $15,000 each to $10,000 each.

The facts of this problem stipulate that the payments to the partners are distributions with respect to their partnership interests. If, contrary to that stipulation, the payments are made to the partners in transactions (such as rendering services) not in their partner capacity, Section 707(a) would alter the foregoing results. *See* Solution to Problem 2.4.

Social Security / Medicare Taxes
(Payroll Taxes, Sel-Employment Tax, and Net Investment Income Tax)

C Corporation

Distributions with respect to stock are not wages subject to the Social Security and Medicare payroll taxes, nor are they net earnings from self-employment, subject to the self-employment tax for Social Security and Medicare. However, dividend income is net investment income, subject to the tax for Medicare under Section 1411 if the recipient's adjusted gross income exceeds the threshold for that tax.

I am aware of no case in which the IRS has sought to recharacterize a C corporation's distributions with respect to its stock as compensation for purposes of the Social Security and Medicare taxes. Given the IRS's success on that issue with S corporations, however, any similar argument with respect to a C corporation would not be a certain loser.

S Corporation

The IRS concedes that pass-through income from S corporations is neither wages nor self-employment income. However, if the IRS successfully demonstrates that a distribution on stock should be recast (wholly or partly) as payment of compensation for services rendered, then to that extent the distribution is treated as wages or independent contractor compensation, with the results discussed in the solution to Problem 2.4. Under the case law, on the distribution, the taxpayers must treat a reasonable amount as compensation if the corporation has not otherwise paid reasonable compensation to the shareholder-worker.

An S corporation shareholder's pass-through income from an S corporation can be net investment income, subject to the Section 1411 Medicare tax if the shareholder's adjusted gross income is high enough. Pass-through income is considered net investment income to the extent that it consists of (a) corporate-level investment income such as dividends or interest income received by the S corporation, or (b) income from the S corporation's business in which a shareholder does not materially participate.

Partnership

The *distributions to the partners* are not income at all, and so they are not subject to Social Security or Medicare taxes. Instead, the key question under those taxes is how to treat the *pass-through* income. Pass-through income cannot be wages, but can it be net earnings from self-employment, or net investment income?

The facts of this problem stipulate that the payments to the partners are distributions with respect to their partnership interests. If, contrary to that stipulation, the payments are made to the partners in transactions (such as rendering services) not in their partner capacity, Section 707(a) affects the results. In that event, the compensation is net earnings from self-employment, and the partners must pay the entire amount of the Social Security and Medicare taxes. *See* Solution to Problem 2.4.

Assuming (as the facts suggest) that Section 707 does not apply, then the following rules govern. The outcome usually depends on whether the service partner is a general partner, a limited partner, or an LLC member.

General Partners

If a partnership is engaged in a business, a general partner's pass-through income from the business is treated as net earnings from self-employment. The partner must pay both halves of the Social Security and Medicare taxes. If the partnership has investment income, the pass-through investment income is net investment income to the partner, subject to the Section 1411 net investment income tax for Medicare, payable at the partner level, if the partner's adjusted gross income exceeds the applicable threshold.

Limited Partners

For limited parters, pass-through income is not wages because partners cannot be employees. Moreover, pass-through income of limited partners is not net earnings from self-employment, because Section 1402(a)(13), set out below, specifically says so. The question that courts have been addressing, and disagreeing about, is what is meant by "limited partner" in this context. The Tax Court has ruled repeatedly that even though someone is a limited partner under state partnership law, they are not a "limited partner" for purposes of Section 1402(a)(13) if they are active in the limited partnership's business. The Fifth Circuit recently reversed the Tax Court in one case, but there are other cases pending before the First and Second Circuits. Under the Fifth Circuit view, a limited partner under state law automatically qualifies for the Section 1402(a)(13) exclusion on pass-through income.

So let's say the partnership is engaged in a business, and partner T is a limited partner who actively participates in the business. In the Fifth Circuit's view, T is in the same boat as an S corporation shareholder – no self-employment tax. The IRS and the Tax Court, on the other hand, treat T the same as a general partner, just discussed.

While the battle rages on about what is meant by "limited partner" for purposes of the *self-employment tax*, there seems to be agreement that a limited partner's pass-through income from a partnership *can* be net investment income, subject to the *Section 1411 Medicare tax* if the partner's adjusted gross income is high enough. Pass-through income is net investment income to the extent that it consists of (a) partnership-level investment income such as dividends or interest income received by the partnership, or (b) income from a partnership business in which the

limited partner does not materially participate. Many limited partners do not materially participate in the partnership's activities; traditionally, none did.

LLC Members

The IRS position on LLC members – and the Tax Court has gone along so far – is that such members are not "limited partners" for purposes of Section 1402(a)(13) if they (a) actively participate in firm business or have a controlling vote, (b) have power to make contracts on behalf of the firm, or (c) are actually liable for firm debts. And of course, they are not "limited partners" under state law, and so the IRS seems to have a stronger case on any appeals court challenge to this position.

Assuming the IRS is right, then if an LLC member in question has any of the three attributes just listed, they are taxed for Social Security and Medicare purposes the way general partners are, discussed earlier. Even under the IRS's view, if the LLC member in question has none of the three attributes, then they are taxed for Social Security and Medicare purposes the way limited partners are, discussed earlier. If the IRS is wrong, and LLC members must get the same treatment as limited partners, then similarly, the earlier discussion of limited partners should apply.

SECTION 1402. DEFINITIONS

(a) Net earnings from self-employment. The term "net earnings from self-employment" means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member; except that in computing such gross income and deductions and such distributive share of partnership ordinary income or loss—

* * * * *

> **(13)** there shall be excluded the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in section 707(c) to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services;

* * * * *

Solution to Problem 2.4

"Regular" Income Tax (§§ 1, 11)

C Corporation

The most likely scenario is as follows:

At the shareholder/worker level, compensation for personal services is ordinary income, $5,000 each.

At the corporate level, the compensation is likely an ordinary and necessary expense, fully deductible by the corporation, of $15,000. This reduces the corporation's taxable income from $15,000 to zero. The corporation pays no tax and has zero earnings and profits for the year.

However, two facts could change the foregoing outcomes:

1. If the compensation is more than a reasonable amount for services actually rendered, the IRS could recharacterize the $5,000 payment each shareholder/worker receives, fully or partly, as a distribution with respect to stock. To the extent such a recharacterization is successful, the shareholder/worker's $5,000 receipt would be, not compensation income, but a distribution on stock. Distributions are covered by Section 301 – dividends to the extent of earnings and profits. Dividends are taxed at capital gain rates.

Under such a recharacterization, the corporation does not get to deduct the distributions on stock. Thus, some or all of its $15,000 taxable profit would constitute taxable income, on which the C corporation would have to pay corporate tax. The corporation's taxable income, minus the corporate tax, would be earnings and profits, giving rise to a dividend at the shareholder level.

For example, if only $3,000 paid to each shareholder/worker is reasonable compensation, then the corporation would deduct only $9,000, leaving $6,000 of taxable income subject to tax under Section 11. The $6,000 minus the corporate tax on it ($1,260) would constitute earnings and profits. Each of R, S, and T would have $3,000 of compensation income, a $1,580 dividend, and $420 tax-free return of basis. Because this might actually be better for the taxpayers overall, the IRS may have no incentive to raise this issue under today's tax rates.

2. Even if the compensation is reasonable, under general tax principles it cannot be deducted by the corporation if it constitutes a capital expenditure,. For example, if the work R, S, and T did was constructing a building, then even if $15,000 is reasonable compensation, it would have to be added to the basis of the building and depreciated by X later. This would be the worst-case scenario, because R, S, and T would have ordinary income, but $15,000 of taxable income would also be taxed at the corporate level under Section 11.

S Corporation

Assume that X has been an S corporation for its entire existence.

The most likely scenario is as follows:

At the shareholder/worker level, compensation for personal services is ordinary income, $5,000 each.

At the corporate level, the compensation is likely an ordinary and necessary expense, fully deductible by the corporation, of $15,000. This reduces the corporation's taxable income from $15,000 to zero. Therefore, the income passing through to the shareholders is zero, and their basis remains stable at $10,000 each

However, two facts could change the foregoing outcomes:

1. If the compensation is more than a reasonable amount for services actually rendered, the IRS could recharacterize the $5,000 payment each shareholder/worker receives, fully or partly, as a distribution with respect to stock. To the extent such a recharacterization is successful, the shareholder/worker's $5,000 receipt would be, not compensation income, but a distribution on stock. Distributions are covered by Section 1368 – tax-free and applied against stock basis.

Under such a recharacterization, the corporation does not get to deduct the distributions on stock. Thus, some or all of its $15,000 taxable profit would constitute taxable income, passing through to the shareholders.

For example, if only $3,000 paid to each shareholder/worker is reasonable compensation, then the corporation would deduct only $9,000, leaving $6,000 of taxable income, which passes through pro rata to the shareholders. Either way, the shareholders have $5,000 of income. However, if the S corporation's income consists entirely of capital gains, the $2,000 each pass-through income is capital gain to the shareholders, whereas the $3,000 compensation income is not.

Under this recharacterization of the transaction, the shareholders' stock basis is affected. When $2,000 of income passes through to each shareholder (regardless of its character as capital or ordinary), the shareholder's stock basis increases from $10,000 to $12,000. When the $2,000 constructive distribution arrives, it reduces the basis back to $10,000. As with C corporations, the IRS may have little incentive to raise this issue.

2. Even if the compensation is reasonable, under general tax principles it cannot be deducted by the S corporation if it constitutes a capital expenditure. For example, if the work R, S, and T did was constructing a building, then even if $15,000 is reasonable compensation, it would have to be added to the basis of the building and depreciated by X later. This would be the worst-case scenario, because R, S, and T would have ordinary income as the recipient of compensation, and additionally, pass-through income of $5,000 each, for total income of $10,000 per shareholder/worker. Their stock basis would increase to $15,000 each, and the corporation would get $15,000 of basis in the building. Extra tax now and basis for later is usually not a good tradeoff for the taxpayer.

Partnership

The IRS takes the position (and most tax advisors agree) that a partner can never be an employee of the partnership. Therefore, the payments to R, S, and T will be considered either partnership distributions covered by Section 731 or payments between independent contracting parties under Section 707(a) (or a mix of the two). Let's assume that the payments were not guaranteed regardless of partnership income – they rarely are – and so Section 707(c), on guaranteed payments, is inapplicable.

Whether the payments are covered by Section 707(a) depends on whether the partner is "acting in [their] capacity as a partner." This question is answered by voluminous regulations and some case law. As a rough approximation of those authorities, if a partner is performing every-day duties of the partnership and being paid on a contingent basis, such as in accordance with company profits, then Section 707(a) doesn't apply.

- *If Section 707(a) doesn't apply*, then the results are the same as in Problem 2.2. The partnership has taxable income of $15,000, which passes through to the partners under Section 702 based on their "distributive" (i.e., economic) shares. Since everything in this partnership is equal among partners, each partner would report $5,000 of pass-through income. The character of that income would be determined at the partnership level. It could be capital gain! When the income passes through, the partners' basis in their partnership interests increases by $5,000 each, from $10,000 to $15,000. When the partner receives the $5,000 as a distribution, it is not taxable, but it reduces the partner's basis in her partnership interest. Each partner ends up with a basis in her partnership interest of $10,000 ($10,000 original basis + $5,000 reaction to pass-through − $5,000 tax-free distribution).

- *If Section 707(a) does apply to the entire payment*, then the partners have compensation income, as if they were independent contractors, of $5,000 each. This is ordinary income. Their basis in their interests is unaffected. At the partnership level, the compensation is likely an ordinary and necessary expense, fully deductible by the partnership, of $15,000. This reduces the partnership's taxable income from $15,000 to zero. Therefore, the income passing through to the partners is zero, and their basis in their partnership interests remains stable at $10,000 each.

  However, under general tax principles the Section 707 compensation cannot be deducted by the partnership if it constitutes a capital expenditure. For example, if the work R, S, and T did was constructing a building, then the $15,000 payment would have to be added to the basis of the building and depreciated by X later. This would be the worst-case scenario, because R, S, and T would have ordinary income as the recipient of compensation, and additionally, pass-through income of $5,000 each, for total income of $10,000 per partner/worker. Their basis in their partnership interests would increase to $15,000 each, and the corporation would get $15,000 of basis in the building. Cold comfort.

Social Security / Medicare Taxes
(Payroll Taxes, Sel-Employment Tax, and Net Investment Income Tax)

C Corporation

If the payments to shareholder/workers are considered entirely compensation, then they are fully subject to the Social Security and Medicare taxes. If the workers are employees, the tax burden is split between the workers and the corporation under the payroll tax system. If the

workers are independent contractors, the compensation is net earnings from self-employment, and the worker must pay the entire amount of the Social Security and Medicare taxes herself.

Any part of the payment that is treated as a disguised distribution on stock is not subject to the foregoing taxes. However, to the extent the shareholder/worker recognizes dividend income, it is net investment income, and subject to the NII tax under Section 1411 (for Medicare) to the extent that the shareholder/worker's adjusted taxable income is above the threshold for that tax. The IRS typically has little or no incentive to raise the disguised dividend issue, because compensation treatment results in more Social Security and Medicare tax.

S Corporation

If the payments to shareholder/workers are considered entirely compensation, then they are fully subject to the Social Security and Medicare taxes. If the workers are employees, then the tax burden is split between the shareholder-workers and the corporation under the payroll tax system. If the workers are independent contractors, then the compensation is net earnings from self-employment, and the shareholder-worker must pay the entire amount of the Social Security and Medicare taxes herself. Compare this unfavorable result with the result of a "pure" distribution on stock. *See* Solution to Problem 2.2.

Any part of the payment that is treated as a disguised distribution on stock is not subject to the foregoing taxes. The IRS has conceded that pass-through income of an S corporation shareholder is categorically neither wages nor net earnings from self-employment. And since it is not gross income, a disguised distribution on stock is not net investment income, either. Here again, the IRS may have no incentive to raise the disguised-distribution issue on the facts of this problem.

If any of the payment to worker-shareholders is reclassified as a distribution on stock, and pass-through income results, the pass-through income can be net investment income, subject to the Section 1411 Medicare tax if the shareholder's adjusted gross income is high enough. Pass-through income is considered net investment income to the extent that it consists of (a) corporate-level investment income such as dividends or interest income received by the S corporation, or (b) income from the S corporation's business in which a shareholder does not materially participate.

Partnership

If Section 707 Applies

To the extent the payments to partners are covered by Section 707, then the compensation is net earnings from self-employment, and the partners must pay the entire amount of the Social Security and Medicare taxes.

If Section 707 Doesn't Apply

To the extent the payments to partners are not covered by Section 707, then the results are the same as in Problem 2.2. The result depends on whether the partner is a general partner, a limited partner, or an LLC member.