# S-CORPORATION PROFIT DISTRIBUTIONS TO A PART-YEAR OWNER

*The purpose of this one-page white paper is to help owners (G-1, G-2 and G-3) understand how to calculate the distributive share of an S-Corporation shareholder for a tax year in which the new shareholder has been an owner for less than a full year.*

## KEY POINTS

1. *This white paper is applicable to new S-Corporation (or LLCs taxed as S-Corps) shareholders who purchase or receive stock on any day of the year other than January 1st.*
2. *New owners (G-2 or G-3) who purchase or receive stock need to understand how distributions of profits (or losses) actually work before they invest.*
3. *Every advisor/investor needs to involve their CPA or tax/legal professional during the planning process, not just the documentation phase.*

Let's start with an appropriate caveat. This *SMP Exclusive* white paper, although written to a high level audience, is not designed to help advisors actually make the following calculations. Instead, this information is meant to help the ownership team (G-1, G-2 and G-3) understand the issues that they need to consider and discuss with their own respective tax and/or legal counsel. More succinctly, if G-2 or G-3 owners are in an S-Corporation ("S-Corp") and don't acquire their stock effective on January 1st, the following information is applicable.

## S-CORP SHAREHOLDERS ARE TAXED ON THEIR "DISTRIBUTIVE SHARE," NOT THEIR ACTUAL DISTRIBUTIONS

To begin, the federal taxation of an S-Corp is unlike that of an ordinary corporation ("C-Corp"). A C-Corp is subject to *double* taxation in the form of taxes at both the corporate and shareholder level, whereas an S-Corp is taxed only *once* at the shareholder level. However, that does not mean that the S-Corp shareholder is taxed on the profits he or she actually receives from the S-Corp. Instead, an S-Corp shareholder pays tax upon a "distributive share."

The calculation of the distributive share depends on the length of time that the shareholder has held ownership in the S-Corp during the year. A full-year S-Corp shareholder has a distributive share equal to their percentage of ownership in the S-Corp, multiplied by the S-Corp's total profit or loss for the year:

*(Shareholder % ownership) • (S-Corp total Profit or Loss during tax year)*

A partial-year S-Corp shareholder has a distributive share equal to their percentage of ownership in the S-Corp, multiplied by the S-Corp's total profit or loss for the year, and then multiplied by the percentage of the year that the new member has been a shareholder:

*(Shareholder % ownership) • (S-Corp total Profit or Loss during tax year) • (# of days new Shareholder owned S-Corp during year / 365)*

This second equation has important implications for part-year S-Corp shareholders. Although the shareholder will receive in actual distributions his or her share of the S-Corp's profit or loss during the time of his or her ownership, the shareholder's distributive share will be based, pro rata, upon the average daily S-Corp profit or loss for the full year. Therefore, the part-year shareholder should expect a difference between the distributive share (taxable income) and the actual distributions received (cash or property), unless the year-to-date ("YTD") profits and losses before the new shareholder's entry are equal to the profits and losses from that date until the end of the year.

## EXAMPLES

**Example 1:** *S-Corp makes less profit after the part-year shareholder is admitted:*

If the S-Corp has a YTD profit before the initial date of the new shareholder's ownership, and a loss (or smaller profit) for the remainder of the year, then the shareholder's distributive share will be greater than the actual distributions received. For example:

- ✓ *S-Corp profit/loss before the shareholder joined in July (midyear) as 50% owner: +$5,000*
- ✓ *S-Corp profit/loss after the shareholder joined: +$1,000*
- ✓ *Actual distribution to the shareholder: (.50) * ($1,000) = $500*
- ✓ *Distributive share to the shareholder: (.50) * ($1,000 + $5,000) * (.50) = $1,500*

In this example, the distributive share is three times greater than the actual distribution to the shareholder. The shareholder must pay taxes on $1,500 yet only receives $500.

**Example 2:** *S-Corp makes more profit after the part-year shareholder is admitted:*

If the S-Corp has a greater profit (or smaller loss) for the remainder of the year following the initial date of the new shareholder's ownership, then the shareholder's distributive share will be less than the actual distributions received. For example:

- ✓ *S-Corp profit/loss before the shareholder joined in July (midyear) as 50% owner: -$2,000*
- ✓ *S-Corp profit/loss after the shareholder joined: +$2,000*
- ✓ *Actual distribution to the shareholder: (.50) * ($2,000) = $1,000*
- ✓ *Distributive share to the shareholder: (.50) * (-$2,000 + $2,000) * (.50) = $0*

In this example, the distributive share is $0, which means that the actual distribution of $1,000 is tax free to the shareholder.

Note that the above examples are basic and make assumptions. One assumption is that the S-Corp has already paid "reasonable compensation" in the form of a salary to each shareholder. Another assumption is that the S-Corp has no retained earnings at the end of the year. Lastly, the examples do not address the calculation of the full-year owners' distributive shares should their ownership percentage change due to the admission of the new shareholder.

## CONCLUSION

The calculation of the distributive share for a newly admitted part-year S-Corp shareholder can lead to tax anomalies. Briefly stated, if the S-Corp has a profit before the new shareholder's admission and a loss (or smaller profit) afterwards, then the new shareholder's distributive share will be greater than the actual distributions, leading to greater taxes. If the S-Corp has a loss before the new shareholder's admission and a profit (or smaller loss) afterwards, then the shareholder's distributive share will be less than the actual distributions, leading to less taxes. There are many other possibilities.

For these reasons, and many others, it is common practice to involve every SMP client's CPA or tax/legal professional in the planning process (Phase One), not just the implementation and documentation process (Phase Two). All current and prospective owners are encouraged to share this white paper with their CPA or tax/legal professional for further evaluation and to consider approaches that may reduce or eliminate the disparity between the distributive share and the actual distributions to a part-year S-Corp shareholder.



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