DID YOU KNOW?

Did you know that you can base partnership tax distributions on cumulative rather than annual income?

Partners in partnerships and members in LLCs often include in the partnership or LLC agreement a provision for tax distributions to provide partners with the cash needed to pay tax on their share of the company's undistributed income. The most common distribution provision provides for a cash payment to each partner (quarterly or annually) equal to such partner's share of company income for the year multiplied by a fixed rate (e.g., 40%) or the highest tax rate applicable to any of the partners.

A fairly common variation is to provide that the tax distribution will be calculated based on the partner's share of the aggregate income of the company. For example, if the company had $100 of losses in year one and $100 of income in year two, the aggregate income would be zero and no tax distribution would be made in year two.

This type of tax distribution may be desirable to maximize the amount of cash retained by the company for use in the business. It is also consistent with how a corporation would pay tax since if a corporation had a loss in year one it would carry forward that loss to offset the income in year two and pay no tax. Some would argue to do otherwise would result in a windfall to the partners who have received a tax refund based on losses in year one which could be applied to pay the taxes in year two.

For many partners, this could result in hardship if his or her share of losses were not deductible (e.g., due to the passive loss limitation) or if the partner has spent the tax refund prior to the year in which the company has taxable income. This potential problem is even more apparent if a number of years have elapsed between the loss year and the profit year.

Bottom Line: Tax distributions based on aggregate income may be highly desirable for well capitalized partners but create a hardship for partners with less financial wherewithal (service partners).

"Hard work never killed anybody, but why take a chance?" – Edgar Bergen

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