



S CORPORATIONS

Tax-Saving Opportunities for "Active" Business Owners

S corporations now provide business owners with a unique opportunity to minimize earnings subject to both the recently imposed additional tax on net investment income and increased employment taxes.

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As the dust settles on the two major pieces of tax reform legislation that went into effect in 2013, S corporations emerge as the entity of choice for many closely held businesses. Taking into account the impact of the two income-based Medicare taxes, the self-employment tax, and the rate differential between individual and corporate tax rates, businesses eligible to be treated as S corporations have opportunities to take advantage of unique provisions not applicable to other types of entities.

Effective 1/1/2013, the Patient Protection and Affordable Care Act (PPACA) and the American Taxpayer Relief Act of 2012 (ATRA) increased the Medicare tax on earned income and introduced a new tax on the net investment income (NII) of high-income individuals. Although the focus of this discussion is on individual business owners, the NII tax also applies to trusts and estates. In addition, 2012 marked the end of the 2% payroll tax holiday, and the expiration of



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Bush-era tax rates for high-income individuals. These changes come together to create a tax climate in which choice of entity can affect the cost of doing business in a way that is big enough to warrant a fresh look at tax planning for closely held businesses and their owners.

Increased Medicare Taxes

For 2013 and thereafter, the Medicare tax on compensation and self-employment income increased from 2.9% to 3.8%. The .9% increase applies to the extent an individual's compensation or self-employment income exceeds the specified threshold amounts (\$250,000 for married individuals filing jointly and \$200,000 for single individuals). The full brunt of the increase falls on the employee, or self-employed individual, with no change to the employer portion of the tax. There is no cap on the amount of compensation or self-employment income subject to the tax. Further, the threshold amounts for the Medicare tax are not indexed for inflation, so that an increasing number of taxpayers will be subject to the tax as time passes. The combined effect of increased income and Medicare tax rates on earned income puts employees at a top rate of up to 39.25%, and self-employed individuals at a top rate of up to 40.7%.

New 3.8% Tax

The new 3.8% Medicare tax on NII functions as a corollary to the Medicare tax on earned income. Subject to limited exceptions, most income of an individual taxpayer is covered by one (but only one) of these taxes. Individuals are subject to the NII tax on the lesser of their NII or modified adjusted gross income over the specified threshold amounts (\$250,000 for married individuals filing jointly and \$200,000 for single individuals, i.e., the same thresholds as for the Medicare tax on earned income). There is no cap on the amount subject to the tax, and the thresholds are not indexed for inflation. An individual's NII is the sum of the individual's passive income (generally, all interest, dividends, annuities, rents, royalties, capital gains, and certain income from a trade or business) less applicable deductions. Trade or business income is included in NII *if the business activity is a passive activity with respect to the taxpayer under Section 469*, or involves trading in financial instruments or commodities. NII does not include any item taken into account in determining self-employment income for the relevant tax year.

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Proposed regulations addressing issues and questions surrounding the NII tax were issued on 11/30/2012. The proposed regulations provide detailed and complex rules for calculating the deceptively simple NII formula. The Preamble to the proposed regulations cautions that the IRS will closely review transactions that manipulate a taxpayer's NII to reduce or eliminate the effect of Section 1411. Note also that the NII tax is subject to the estimated tax provisions.

Individual Rate Now Tops Corporate

For the first time since 2003, corporate and individual rates have flip-flopped, and the maximum income tax rate applicable to individuals is now significantly higher than the rate applicable to corporations. The top individual income tax rate for 2013 is 39.6% for ordinary income and 20% for long-term capital gains and qualified dividends. The top corporate income tax rate for 2013 remains at 35% however, for both ordinary income and capital gains.

Less Obvious Tax Increases

In addition to higher individual income tax rates, the phase-out of personal exemptions and disallowance of itemized deductions results in an even higher effective marginal tax rate for high-income taxpayers. Beginning in 2013, an individual's personal exemptions are partially phased out for adjusted gross income over the specified amount (\$254,200 for 2014), and itemized deductions are disallowed in an amount equal to 3% of adjusted gross income over the specified amount, with the maximum amount disallowed equal to 80% of itemized deductions.

Disparity in Treatment of Different Entity Types

Entity owners must navigate the rules relating to the various taxes that are potentially applicable to their business income, whether in the form of dividends, salary, or sale proceeds. The application of these rules varies significantly with the choice of entity as discussed below.



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C Corporations

For C corporation shareholders, the NII tax applies to any dividends paid by the corporation and to any gain on the sale of the C corporation stock. The level of a C corporation shareholder's participation in the corporation's business is irrelevant for purposes of the NII tax. In contrast to partnerships, limited liability companies (LLCs), and S corporations, the NII tax applies to income from a C corporation *regardless* of whether the corporation's business is active or passive with respect to any shareholder.

The self-employment tax does not apply to C corporation dividends or to any gain on the sale of C corporation stock. The salary of a C corporation shareholder who is employed by the corporation is subject to the Medicare tax on earned income, at the new higher rate for 2013, with no cap on the compensation subject to the tax.

C corporations benefit from the relatively lower corporate income tax rate, when compared to the top individual income tax rate. However, this corporate-level advantage is generally outweighed by the increased tax burden at the shareholder level. The cost of withdrawing corporate earnings has substantially increased, with rising individual rates and the addition of the NII tax. Every dollar earned by a C corporation is subject to tax at 35% at the corporate level, and then again on distribution as a dividend to shareholders at the applicable individual income tax rate, with the addition of the 3.8% NII tax for high-income shareholders.

Partnerships and LLCs

The treatment of an owner of a partnership interest, including interests in an LLC taxed as a partnership, depends on whether the business is passive with respect to the owner for purposes of the NII tax rules, and whether the owner is treated as a "limited partner" for purposes of the self-employment tax rules.

An individual partner's NII includes the partner's share of flow-through income from a partnership only to the extent the income is derived from a partnership activity that is a passive activity with respect to the partner (or from trading in financial instruments or commodities), or represents a

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share of the partnership's investment income. The material participation test under Section 469 applies to determine whether an activity is passive with respect to a partner. Under the test, a partner materially participates in an activity if the partner's involvement in the operation of the activity is regular, continuous, and substantial. Thus, in the case of a passive partner, the new NII tax applies to the partner's entire distributive share of partnership income. On the other hand, if a partner materially participates in the partnership's business, the NII tax does not apply to the partner's income from the partnership except to the extent the partner receives a guaranteed payment for services.

The gain or loss included in NII with respect to the sale of a partnership interest is limited to the gain or loss that would be recognized in a hypothetical sale of the partnership's assets. Any gain recognized on the distribution of money in excess of a partner's adjusted basis in the partnership interest is also treated as gain from the sale or exchange of the partnership interest, for purposes of the NII tax.

Unfortunately, even a partner whose level of participation avoids the NII tax will likely be subject to self-employment tax on the partner's entire distributive share of the partnership's income, as well as any gain on sale of a partnership interest.

As a general rule, self-employment income includes a partner's entire distributive share of flow-through income from a partnership. An exception applies to the distributive share of a "limited partner," which is subject to self-employment tax only to the extent of any guaranteed payment to the partner for services actually rendered to or on behalf of the partnership.²⁰ The term "limited partner" is not defined in the Code, and no definitive guidance has been issued on how the exception should be applied in the case of an LLC or other state law entity taxed as a partnership. Proposed regulations were issued in 1997, but never finalized, that include a relatively narrow definition of "limited partner," particularly in the case of service partnerships. The definition of "limited partner" under the proposed regulations does not include an individual who either:

- (1) Has personal liability for the partnership's debts.
- (2) Has authority to contract for the partnership.
- (3) Participates in the partnership's business more than 500 hours in a year.

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A partner who participates in the business more than 500 hours per year, but otherwise qualifies as a limited partner and who owns only one class of partnership interest may be treated as a limited partner under the proposed regulations so long as at least 20% of the remaining partnership interests are held by limited partners who have identical rights but who provide no services to the partnership. However, in the case of service partnerships in specified professional fields, any partner who performs more than a de minimis amount of services cannot be treated as a limited partner under the proposed regulations.

The additional Catch-22 for an actively involved limited partner or LLC member is that the level of participation required to qualify a partnership activity as active, with respect to the partner under the NII tax rules, is likely to disqualify the limited partner or LLC member as a "limited partner" under the self-employment tax rules. These rules simply *were not drafted and have not been updated to adequately address limited liability company members* (or limited partners in LLPs or other newer versions of tax partnerships under state law).

S Corporations

Passive shareholders in an S corporation are treated much like passive investors in partnerships. The NII tax applies to the entire distributive share of S corporation income allocable to a shareholder, to the extent the income is derived from activity that is passive (or from trading in financial instruments or commodities) or represents the corporation's investment income. As with partners, the material participation test under Section 469 applies to determine whether an activity is passive with respect to an S corporation shareholder. A shareholder who materially participates in the business avoids the NII tax on the shareholder's entire distributive share of the S corporation's income. As with a partnership, gain or loss on the sale of S corporation shares is included in NII only to the extent of the gain or loss that would be recognized in a hypothetical sale of the S corporation's assets, i.e., to the extent gain or loss is derived from an activity that is passive as to the S corporation shareholder. Any gain recognized as a result of a distribution of money in excess of a shareholder's adjusted basis in the S corporation's stock is treated as gain from the sale or exchange of the stock. In the case of sale of S corporation stock with a Section 338(h)(10) election, NII includes the shareholder's pro rata share of the corporate level gain on the deemed asset sale, as well as any additional gain on the deemed liquidation.

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A shareholder-employee of an S corporation is subject to employment taxes (including the Medicare tax on earned income at the new higher rate for 2013) on compensation for services that the shareholder provides to the S corporation. However, the self-employment tax *does not apply* to an S corporation shareholder's distributive share of the corporation's income.

Conclusion

The ability to bifurcate an S corporation shareholder's compensation for services from the shareholder's distributive share of the corporation's income provides an opportunity to minimize earnings subject to the additional layer of NII and employment taxes. *The caveat is that reasonable salary must be paid.* With the increase in taxes on earned income, the IRS has added incentive to challenge the allocation of S corporation payments between salary and distributions. If the IRS determines that salary paid to an S corporation shareholder is too low, a portion of distributions to the shareholder might be recharacterized as wages.

The bottom line for S corporations is that a passive shareholder is subject to the NII tax on the shareholder's distributive share of the corporation's income as well as any gain on sale, while a shareholder who materially participates avoids both the NII tax and self-employment tax on the shareholder's distributive share of income and any gain on sale. S corporation shareholders who are actively involved in the corporation's business will want to look at planning opportunities to meet the material participation standard. New entities that can be structured as an S corporation should consider a careful allocation of payments to active shareholders, between compensation for their personal services and distributions, representing a share of the corporation's profits as a return on investment.

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