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"Affordable Care Act" Creates Additional Tax Complication for Flow Through Entities

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Tax Talk

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Background

Section 1411, which was added to the Internal Revenue Code (the Code) as part of the Patient Protection and Affordable Care Act (the Affordable Care Act) and is effective for taxable years beginning after December 31, 2012, imposes a 3.8% surtax (the Medicare surtax) on the "net investment income" of certain individuals, estates and trusts.

Earlier installments of *Tax Talk* have explained in detail how the Medicare surtax is calculated and discussed some of the complications facing trusts that hold S corporation stock.[1] As explained previously, the definition of net investment income (NII) is quite broad. NII not only includes all of the items one would expect, e.g., interest, dividends, capital gains, royalties and certain rents, but also includes trade or business income that flows through to business owners who do not "materially participate" in a business conducted by a flow through entity such as an S corporation, limited liability company or partnership. For these purposes, material participation is determined by applying the rules of Code Section 469 and the regulations issued thereunder. Among those rules is the 500-hour test, which generally provides that an owner who participates in a business for more than 500 hours per year materially participates in the business.

Business owners who conduct their business through a flow-through entity such as an S corporation or a partnership often make gifts of their stock or partnership units to children or younger family members (or to trusts for their benefit). These gifts frequently take the form of non-voting stock or partnership units, though this is not legally required. Often, the donees of the stock or partnership units are not active in the business because of their age, other responsibilities or interests. As a result, it is common to have some interests in flow-through entities held by "active" participants, i.e., equity holders who materially participate in the conduct of the business, while other interests are held by passive investors, i.e., individuals who own equity but play little or no role in the conduct of the business. The income of the flow-through entity allocated to active participants will not constitute NII and will not be subject to the Medicare surtax.[2] Conversely, the income of the flow-through entity allocated to passive investors will be NII and may be subject to the Medicare surtax depending on the investor's other tax attributes.

Example: Dad is the founder of FroGa, Inc., an S corporation, which owns and operates a frozen yogurt/yoga studio in Chicago. On December 31, 2012, right before he thought the estate and gift tax rules were about to be materially tightened, Dad gave 25% of the shares of FroGa, Inc. to each of Son and Daughter. Assume that both Dad and Daughter, a certified yoga instructor, materially participate in the business. Son is a surgeon living in California and has no role in the business. Dad and Daughter each are residents of Illinois. Son's distributive share of FroGa, Inc.'s income will constitute NII and will be subject to the Medicare surtax if Son's modified adjusted gross income exceeds the applicable threshold amount, which is $250,000 for married taxpayers filing jointly, $125,000 for married taxpayers filing separately, and $200,000 for everyone else. The Medicare surtax will not apply to Dad or Daughter because both of them materially participate in the business.

Tax Distribution Formula Clauses

It is common for the organic documents (e.g., the shareholder agreement, partnership agreement or limited liability company operating agreement) of a flow-through entity to require the entity to make distributions to each of its owners in amounts sufficient to protect them from the income tax burden of the entity that effectively is shifted to the tax returns of the individual owners. Typically, such agreements either (a) look to the maximum marginal combined federal, state and local income tax rates applicable to the owner who happens to live in the highest state/local tax jurisdiction[3] and then use that rate to make a "tax dividend" or "tax distribution" to all the owners or (b) for simplicity, either (i) pick an assumed combined income tax rate (e.g., 45%) or (ii) assume that all owners are domiciled in the same state to allow the entity to identify a combined federal, state and local income tax percentage to be used. The first approach may result in tax dividend overpayment to the owners who are resident in states that have a lower state income tax or no state income tax. If the entity is an S corporation, it must pay identical dividends per share to avoid the prohibition against having more than one class of stock. In theory, partnerships and LLCs offer their owners more flexibility to make non-pro-rata distributions; in practice, however, tax distributions are typically paid to the partners or unit holders pro rata as a matter of fairness.

Example: FroGa, Inc. has taxable income of $1,000 for 2013, which is allocated $500 to Dad, $250 to Daughter and $250 to Son. Assume the combined highest marginal federal, state and local income tax rate (taking into account the deduction for state income taxes for federal income tax purposes) is 50% for residents of California and 43% for residents of Illinois. The shareholders of FroGa, Inc. have entered into a shareholders agreement requiring the company to make tax distributions to all shareholders using the rate applicable to the shareholder residing in the highest state and local taxing jurisdiction. As a result, FroGa will make a tax distribution of 50% of its taxable income ($250 to Dad and $125 each to Son and Daughter) so that Son's liability attributable to his share of FroGa, Inc.'s income is covered under all circumstances. Dad and Daughter receive a bit of a windfall since their actual combined income tax liabilities in respect of the company income do not exceed 43%.

Impact of Section 1411

The Medicare surtax is not technically an income tax. Like the self-employment tax, it is a separate tax unto itself. So tax dividend formula clauses will not work if, as illustrated above, they are drafted with an eye toward the hypothetical income taxes that will be owed by the flow-through entity's owners in connection with their respective shares of the entity's taxable income and gain. Typically, these clauses are not drafted broadly enough to include the Medicare surtax, either because the Affordable Care Act was not enacted, or simply was not considered, when the tax dividend formula was created. Executing a short amendment to the applicable agreement will be relatively easy to accomplish in many instances, where all of the owners are on the same page and their interests are aligned. But even in the simple example set forth above, Dad and/or Daughter may be opposed to making further distributions out of the business for the Medicare surtax—a tax that, as active participants in the business, they will not owe. Instead, they may have plans for expansion of the business and a desire to retain the maximum amount of corporate earnings. On the other hand, Dad might have a different view in the future, after he retires and no longer materially participates in the business, causing his income from the business to be treated as NII.[4]

Even if all of the owners are in agreement, if a lender is involved, there will likely be loan covenants that dictate the extent to which tax or other distributions can be made to the business owners. We have already been involved in renegotiations of loan covenants in which the business owners sought to broaden the permissible tax distribution covenants to include the Medicare surtax. Some lenders are more sympathetic than others in this regard. Since the Medicare surtax is supposed to be paid quarterly (along with estimated income taxes), it is important to identify this issue earlier, rather than later, in the tax year and to open the dialogue with applicable lender(s) now rather than on April 15 of next year.

The media is full of reports of certain aspects of the Affordable Care Act being postponed due to the perceived complications of its implementation. To date, the Medicare surtax is not one of those provisions. It became effective on January 1 of this year and will likely catch a number of taxpayers off guard, both as to its reach and as to the amount of tax liability they may owe.

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[1]See “New 3.8% Affordable Care Act” Tax May Burden Some S Corporation Shareholders (February 19, 2013); and “Increased Medicare Tax on High-Income Taxpayers and the Medicare Tax on Unearned Income.” (June 25, 2010)

[2]However, such income may be net earnings from self-employment and which is subject to a (different) 3.8% self-employment tax on amounts earned in excess of the annual threshold amount ($113,700 during 2013). Net earnings from self-employment up to the amount of such annual threshold are subject to a combined old age, survivors and disability (OASDI) tax of 12.4% and Medicare Hospital Insurance (HI) tax of 2.9% for a total tax of 15.3%. The HI tax continues even above the annual threshold. Beginning in 2013, the HI tax was increased by .9% (to 4.8% all in) for taxpayers with income over the applicable threshold amount (e.g., $250,000 for married taxpayers filing joint returns, $125,000 for married taxpayers filing separately and $200,000 for single taxpayers)

[3]Such formulas typically reduce the overall rate by taking into account the deductibility of state and local taxes for federal income tax purposes.

[4]Under Section 469, Dad will not likely be deemed to have passive income from FroGa until the beginning of the sixth year following his retirement. *See* Treas. Reg. §1.469-5T(a)(5).