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Tax Planning for the “New Normal”

Effective January 1, 2013, the American Taxpayer Relief Act of 2012 (“ATRA”) was enacted into law, finally settling years of debate over the fate of the Bush era tax cuts. On the same day, the 3.8% Medicare Tax on net investment income that was part of 2010’s Health Care Act went into effect. These two developments have changed some of the fundamental assumptions made over the last decade concerning how to structure ownership of business interests from a tax perspective. During that time period, the top individual and corporate federal income tax rates were equal, with both being set at 35%. Although qualified dividends were accorded a preferential 15% tax rate, a C corporation was generally the least tax-efficient form of doing business. A C corporation’s net income was subject to tax at a maximum rate of 35% at the corporate level, and then after-tax net income that was distributed to shareholders was subject to tax at the 15% rate imposed on dividends. In contrast, “pass through” forms of doing business, such as S corporations, partnerships and limited liability companies (“LLCs”) taxed as partnerships or disregarded entities were (and still are) subject to only one level of tax. The net income of such entities was taxed directly to their individual owners, at the same maximum rate of 35%. Distributions from such entities, however, were (and still are) not subject to tax, thus avoiding the second level of tax imposed on dividends from C corporations. Even if a business contemplated reinvesting profits back into the business rather than distributing profits to the business’ owners, using a pass-through entity would leave the business in no worse shape from a tax standpoint because profits were subject to the same top 35% tax rate whether they were taxed directly to the owners or at the corporate level.

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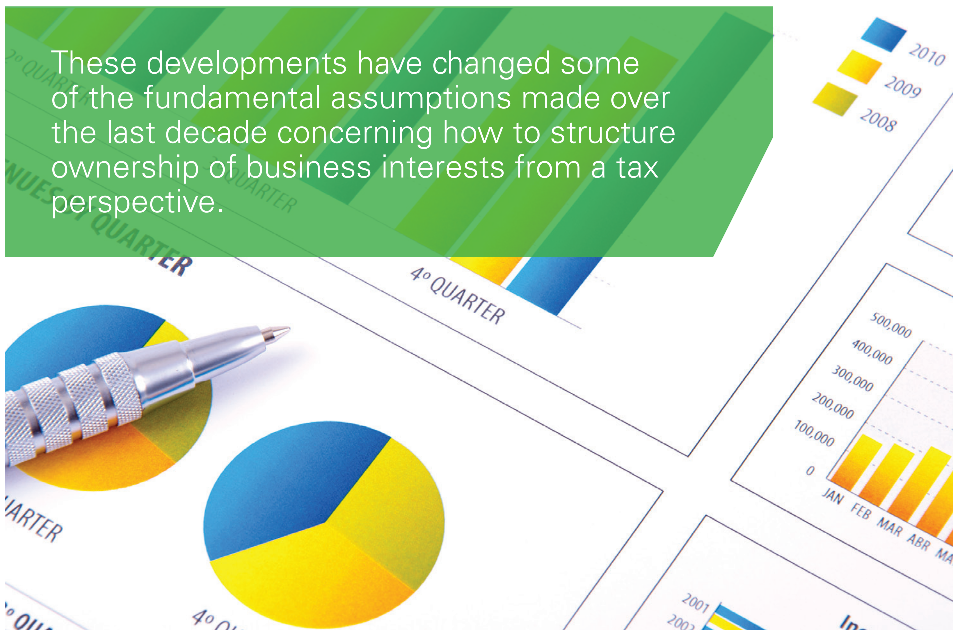

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Under ATRA the planning environment has materially changed. C corporations are still subject to a maximum federal income tax rate of 35%. In contrast, individuals who are married and file jointly are subject to a maximum federal income tax rate of 39.6% on taxable income in excess of $450,000 ($400,000 for single filers). The 3.8% Medicare Tax on investment income can push the top aggregate marginal federal income tax rate up to 43.4%. At the same time, while ATRA increased the top federal income tax rate on dividends from C corporations, it made the preferential tax treatment of dividends permanent rather than allowing dividends to revert back to being taxed at regular income tax rates as was scheduled to occur at the end of 2012. Under ATRA, dividends are taxed at a top federal income tax rate of 20% for married individuals filing jointly with taxable income in excess of $450,000 ($400,000 for single filers). For taxpayers below this income threshold, dividends continue to be taxed at a rate of 15%. These changes have important planning implications.

Choice of Entity Considerations. Since, as a result of ATRA, individual taxpayers are subject to a significantly higher top marginal federal income tax rate than corporate taxpayers, in some instances it may be more tax efficient to conduct business as a C corporation than as a pass-through entity. This is particularly true of a small business. C corporations are subject to federal income tax at a rate of 15% on net income up to $50,000, 25% on net income from $50,001 to $75,000, 34% on net income from $75,001 to $10 million and 35% on amounts in excess of $10 million. Assume a married individual that is in the top federal income tax bracket of 39.6% owns a small business in which he or she does not materially participate (more on this in the next section). Assume also, that the business has taxable income of $50,000 for 2013. Finally, assume that the taxpayer and his or her spouse has other net investment income in excess of $250,000. If the taxpayer conducts the business through an LLC of which he or she is the sole owner, the LLC will be a disregarded entity (unless he or she expressly elects otherwise) that is ignored for federal income tax purposes and its $50,000 in net income will be taxed directly to the taxpayer. At a rate of 39.6% this will result in tax of $19,800. In addition, because the taxpayer does not materially participate in the bakery business, the $50,000 in net income will also be subject to the 3.8% Medicare Tax on net investment income, resulting in additional tax of $1,900 for a total of $21,700 in total tax. In contrast, if the taxpayer instead conducted the bakery business through a C corporation, it would pay tax on the net income at a rate of 15%, resulting in corporate level tax of $7,500. If the corporation then paid an after-tax dividend of $42,500 to the taxpayer, it would be subject to tax at a rate of 20%, resulting in an additional $8,500 of tax. The 3.8% Medicare Tax would also apply to the dividend, generating $1,615 in tax. In total this amounts to $17,615 in corporate and individual income tax, over $4,000 less than the tax generated by a business conducted through a pass-through, single member LLC.

The foregoing is a highly simplistic and, perhaps, somewhat unrealistic factual scenario. Nonetheless it illustrates the point that it is no longer correct to simply assume that conducting business through a pass-through entity will produce tax results superior to doing so through a C corporation. Instead, one should consider, among other things, the tax brackets of the business owners, the extent to which the owners will be able to use deductions that may flow through to the owners from a pass-through entity, the projected profitability of the business, whether profits will be distributed to the business owners or reinvested in the business and, as discussed in the next section, whether the business owners materially participate in the business.

Planning for the 3.8% Medicare Tax on Net Investment Income. The 3.8% Medicare Tax on net investment income is imposed on the lesser of a taxpayer's (1) net investment income or (2) the excess, if any, of the taxpayer's modified adjusted gross income over $250,000, if the taxpayer is married filing jointly, or $200,000 if the taxpayer is a single filer. "Investment" income is defined as income from interest, dividends, annuities, royalties and rents, as well as other income from a trade or business that is not a "passive activity" with respect to the taxpayer, or which consists of trading in financial interests or commodities, as well as gains recognized on the disposition of property that generates such income. Expenses incurred with respect to investment income are deducted from such income to arrive at net investment income.

With respect to income derived from a trade or business, the statute incorporates the definition of "passive activity" that is used for purposes of the limitation on deduction of passive activity losses. Under these rules a trade or business activity is passive to a taxpayer if the taxpayer does not "materially participate" in the activity. By regulation the IRS has established seven alternative tests for determining whether a taxpayer materially participates in a trade or business activity. A detailed discussion of these tests is beyond the scope of this article. Generally speaking, however, a taxpayer's involvement in a trade or business must be "regular, continuous and substantial." Under one of the regulatory material participation tests, this requirement is satisfied if a taxpayer spends more than 500 hours participating in the activity during the year. Under the other tests, a taxpayer can meet the material participation standard with less than 500 hours participation if substantially all the participation in the activity is by the taxpayer, no other individual participates more than the taxpayer in the activity or other factors indicate the taxpayer is actively engaged in the trade or business. Rental activities are subject to more stringent material participation requirements.

Significantly, trade or business income from partnerships (including LLCs taxed as partnerships) and S corporations that is taxed to an owner is not subject to the 3.8% Medicare Tax if the owner materially participates in the trade or business. This exception also applies to gain recognized on the sale of a partnership interest or S corporation stock by an owner who materially participates in the trade or business. While this creates planning opportunities for reducing the amount of Medicare Tax imposed on the income of S corporations, doing so with respect to partnerships presents certain challenges notwithstanding the fact that partnerships nominally qualify for the exception. This is because, starting with the case of a service partnership, all income allocable to partners is treated as income from self-employment. Income from self employment has always been subject to Medicare Tax. Starting in 2013, the top Medicare Tax rate imposed on self-employment income is 3.8%, just like the Medicare Tax on net investment income. Thus, although a partner materially participating in a service partnership avoids the 3.8% Medicare Tax on net investment income, the partner will be subject to the 3.8% Medicare Tax on self employment income. Even in the case of non-service partnerships, the IRS generally takes the view that if a partner materially participates in the partnership's trade or business, all of his or her income is taxed as income from self-employment. The IRS has from time to time informally blessed partnership arrangements that bifurcate a partner's share of partnership income into compensation from self-employment and investment return, but the IRS has not issued any clear, binding guidance on the subject. Moreover, it is not always possible to structure the economic relationship between partners in a manner consistent with the IRS' informal guidance concerning such structuring.

In contrast to partnerships, income allocable to S corporation shareholders is not considered income from self-employment even if the S corporation is engaged in a service business. As a result, some business owners may consider converting trades or businesses from partnerships to S corporations. By the same token, because there is no exception to the 3.8% Medicare Tax on net investment income for dividends paid by C corporations to shareholders that materially participate in a C corporation's business, it may make sense to elect S corporation status for a C corporation. Of course, the Medicare Tax savings would need to be balanced against the higher top marginal income tax rate imposed on individuals, as described in the preceding section of this article.

The material participation exception raises interesting ownership structuring issues with respect to S corporation shares held in trust. Trusts can qualify to hold S corporation stock in three ways: (1) as a "grantor trust," which by virtue of the terms of the trust results in the person who created the trust (the "grantor") being treated as if he or she owns the S corporation stock directly, (2) as a "Qualified Subchapter S Trust" ("QSST"), pursuant to which the sole beneficiary of a trust agrees to be taxed on the S corporation income allocable to the shares held by the trust and (3) as an "Electing Small Business Trust" ("ESBT") pursuant to which the trust itself is taxable on all of the income allocable to the S corporation shares it holds, even if that income is distributed to the trust's beneficiaries. Who must materially participate in the business of an S corporation to qualify for the exception to the Medicare Tax on net investment income will vary depending on how the trust qualifies to hold the S corporation stock. In the case of a grantor trust, because the grantor is treated as if he or she owns the S corporation stock held by the trust, the grantor must materially participate in the business of the S corporation to qualify for the exception. In contrast, because it is the beneficiary who is taxed on S corporation income allocable to shares held by a QSST, it is the beneficiary who must materially participate to qualify for the exception.

Satisfying the material participation standard in the context of an ESBT is a somewhat murky proposition. Neither the statute nor IRS proposed regulations regarding the Medicare Tax on net investment income directly address this issue. However, based on two private letter rulings issued by the IRS regarding the passive activity loss limitation provisions, it appears that the IRS position is that the trustee of an ESBT must materially participate in the trade or business of the S corporation in order to qualify for the Medicare Tax exception. This may present a hurdle to satisfying the material participation requirement in many instances because the trustee of a trust often does not have the time, background or ability to be involved in an S corporation's trade or business on a regular, continuous and substantial basis. In some circumstances it may be possible to replace an ESBT trustee with an individual who does materially participate in the S corporation's trade or business, but often an individual who does so may not want to take on the responsibilities (and potential liability) associated with being a trustee. Under such circumstances it may be possible to satisfy the material participation standard by appointing a "special trustee" to work in the S corporation's business. That said, in its rulings the IRS has indicated that the trustee who materially participates in the trade or business must do so in a fiduciary capacity with the full power and authority of a trustee. Therefore, if a special trustee is appointed, he or she will have to have all of the powers and responsibilities of a full trustee insofar as the S corporation's activities are concerned.

It is worth noting that the IRS position concerning material participation by the trustee conflicts with the only court decision that has considered the issue. In that case a federal district court in Texas ruled that a trust could satisfy the material participation requirement under the passive loss limitation rules through the employees and independent contractors that the trustee hired to operate a business on behalf of the trustee. This makes good common sense and provides support for the position that the trustee himself or herself does not have to participate in the trade or business directly for a trust to satisfy the material participation standard. However, most taxpayers will likely be more comfortable attempting to comply with the IRS position in order to avoid a challenge by the IRS upon audit of the trade or business.

The foregoing discussion illustrates that it is no longer "business as usual" as far as evaluating the optimal entity and ownership structure for organizing business activities from a federal income tax perspective. The combination of the passage of ATRA together with the imposition of the 3.8% Medicare Tax on net investment income has turned some traditional tax planning assumptions on their head. Moreover, what works best will vary widely from business to business depending on the particular facts and circumstances of the business and its owners. Rather than relying on general rules of thumb, putting in place the most tax-efficient structure will require consultation with tax advisors and crunching the numbers. This may prove to be a somewhat painful task, but doing so can result in substantial tax savings in the long run.