S CORPORATIONS Revisited?

Choice of Entity in Light of the 2013 Medicare Surtaxes

by Kelly C. Mooney, J.D., L.L.M. & Timothy D. Brown, J.D.

The 2012 year witnessed a host of activity and changes with respect to the federal tax laws, including the U.S. Supreme Court's decision upholding the Patient Protection and Affordable Care Act1 and the re-election of President Obama. The combination of these events ensured the introduction of two new Medicare surtaxes in 2013, namely the 3.8% net investment income tax ("*NII*") under Internal Revenue ("*IRC*") § 141[1] and the 0.9% additional Medicare tax ("*AMCT*") under IRC §§ 3101(b) and 1402. Both of the new surtaxes went into effect on January 1, 2013 and serve to increase taxes on the earned and investment income of higher-income taxpayers.

Perhaps unexpectedly, the introduction of the AMCT and NII surtaxes favors the use of S corporations[2] over other types of pass-through entities in certain cases. The use of an S corporation, unlike a limited liability company[3] ("LLC") or partnership, can prevent the imposition of self-employment taxes (provided that "reasonable compensation" is paid to shareholder-employees) and the imposition of the AMCT surtax on S corporation allocations. These benefits are largely unavailable to the owners of partnerships and LLCs. Consequently, 2013 and beyond may see a renewed proliferation of S corporations in the context of service oriented businesses.

This article briefly explains the operation of the new AMCT and NII surtaxes and then considers the choice of entity ramifications of the new taxes for 2013 and beyond.

The 0.9% AMCT

The AMCT increases the Medicare taxes payable on the wages and self-employment income of certain high-income taxpayers by 0.9%. Currently, employees pay Social Security tax at a rate of 6.2% on the first $113,700 of wages in 2013 and Medicare tax at a rate of 1.45%.[4] Self-employed individuals pay Social Security tax at a rate of 12.4% on the first $113,700 of self-employment income in 2013 and Medicare tax at a rate of 2.9%.[5] For purposes of this article, wages and self-employment income subject to Social Security and Medicare tax are referred to as "earned income."

The 0.9% AMCT is imposed on earned income in excess of $250,000 for married couples filing joint, $125,000 for married couples filing separate, and $200,000 in all other cases.[6] In the case of employees, the AMCT increases the employee side Medicare tax from 1.45% to 2.35% on wages in excess of the thresholds. There is no employer portion of the AMCT. Employers, however, are required to withhold AMCT from wages paid to an individual in excess of $200,000 in a calendar year without regard to the individual-employee's filing status or amount of other wages or compensation.[7] The employer's obligation to withhold AMCT commences when wages paid to an individual-employee exceed $200,000.[8] Employees cannot request that employers withhold AMCT on wages under $200,000. As a result, married couples who expect that their combined wages will create AMCT liability should consider requesting additional income tax withholding or making estimated tax payments.

For example, assume individual A, who is married and files a joint return, receives $190,000 in wages from his employer for the calendar year. Individual B, A's wife, re-

ceives $150,000 in wages from her employer for the same year. Neither A's or B's employer is required to withhold AMCT because neither A's or B's wages exceed $200,000. However, A and B are liable for AMCT in the amount of $8,100 ($340,000 combined wages minus the $250,000 married filing joint threshold equals $90,000 times the 0.9% AMCT).[9]

In the case of self-employment income, the AMCT increases the Medicare tax from 2.9% to 3.8% on self-employment income in excess of the thresholds, with one caveat – the threshold is reduced to the extent of wages reported by the taxpayer (or the taxpayer's spouse if a joint return is filed).[10] As an example, assume individual C, who is married but files separate, receives $150,000 of self-employment income and $200,000 in wages in the same calendar year. Since C's wages do not exceed $200,000, C's employer does not withhold AMCT. Nonetheless, C's wages reduce his $125,000 AMCT threshold as married filing separate to $0. C is liable for $675 of AMCT on his wages (0.9% times $75,000($200,000 - $125,000)) and $1,350 of AMCT on his self-employment income (0.9% times $150,000($150,000 - $0)) for a total AMCT liability of $2,025.11

The 3.8% NII

The NII picks up where the AMCT on earned income leaves off. The NII imposes a 3.8% surtax on net investment income in cases in which a taxpayer's "modified adjusted gross income" exceeds the same thresholds applicable to the AMCT.[12] Modified adjusted gross income for these purposes is adjusted gross income plus certain otherwise excluded foreign income.[13] Thus, although the AMCT and NII income thresholds are the same, the tax base is different – earned income for AMCT and modified adjusted gross income for NII. The NII represents the first ever expansion of Medicare taxes into the realm of investment income.

Investment income subject to the 3.8% NII includes the following items: (i) gross income from interest, dividends, annuities, royalties, and rents, other than income generated in the ordinary course of a trade or business; (ii) gross income derived from a trade or business that is either a passive activity under IRC § 469 or that consists of the trading of financial instruments or commodities; and (iii) net gain attributable to the disposition of property, other than property held in a trade or business that is neither a passive activity nor consists of the trading of financial instruments or commodities.[14] In cases involving a pass-through entity, the determination of whether income is generated by a trade or business or constitutes investment income is made at the entity level rather than the owner level.[15] However, even if income under categories (i) and (iii) is not investment income at the entity level, it can be investment income at the owner level if the owner is inactive (i.e., does not materially participate in the activity or the activity is a rental activity).[16]

For example, if a small loan company classified as an S corporation earns interest on its loans in the ordinary course of its business, the company's interest income is not investment income at the entity level. However, the company's interest income is investment income to an inactive shareholder at the owner level and potentially subject to the 3.8% NII.[17] Similarly, if a partnership sells a capital asset not held in its trade or business, the gain is investment income at the entity level and investment income for each of the partners.[18] On the other hand, if a partnership sells equipment used in its trade or business, any gain is not investment income at the entity level but will be investment income to any inactive partners. Moreover, distributions from pass-through entities that are in excess of the owner's basis generally are taxed as capital gain and, thus, are investment income potentially subject to the 3.8% NII.

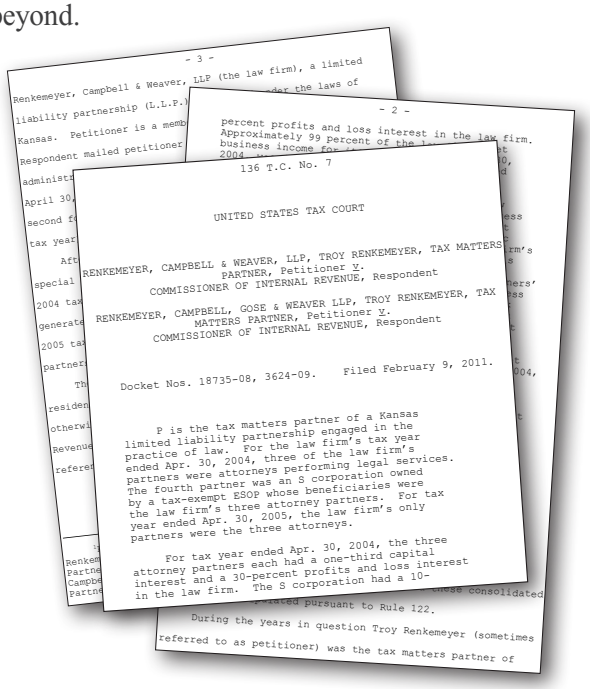
In determining NII, the three categories of investment income discussed above are reduced by deductions that are properly allocable to the income, provided that only amounts paid or incurred to "produce" the investment income are deductible.[19] However, since NII for any year cannot be less than zero, if a deduction is not fully used in the current year, the balance can be carried forward to another year if the Code section permitting the deduction allows for carryovers.[20] Properly allocable deductions include depletion under IRC § 62(a)(4), trade or business deductions covered by IRC § 62(a)(1), investment expenses, taxes, and miscellaneous itemized deductions after the application of the 2% floor, among others.[21]

Neither the AMCT or NII are indexed for inflation. As a result, more and more individuals will likely be subject to these taxes as time passes.

Choice of Entity Ramifications

Although the taxes imposed by the AMCT and NII are relatively small, these new surtaxes intensify a disparity that has long existed with respect to the self-employment tax ramifications of doing business through an S corporation or partnership vehicle. In addition, these taxes are being introduced

at a time when the self-employment tax treatment of limited partners has been called into question by the U.S. Tax Court's landmark decision in *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011). Both favor the use of S corporations for active, service-provider owners in 2013 and beyond.


- 3 -

Renkemeyer, Campbell & Weaver, LLP (the law firm), a limited liability partnership (L.L.P.)

Kansas. Petitioner is a memb

Respondent mailed petitioner

- 2 -

percent profits and loss interest in the law firm. Approximately 99 percent of the

136 T.C. No. 7

UNITED STATES TAX COURT

RENKEMEYER, CAMPBELL & WEAVER, LLP, TROY RENKEMEYER, TAX MATTERS PARTNER, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

RENKEMEYER, CAMPBELL, GOSE & WEAVER LLP, TROY RENKEMEYER, TAX MATTERS PARTNER, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 18735-08, 3624-09. Filed February 9, 2011.

P is the tax matters partner of a Kansas limited liability partnership engaged in the practice of law. For the law firm's tax year ended Apr. 30, 2004, three of the law firm's partners were attorneys performing legal services. The fourth partner was an S corporation owned by a tax-exempt ESOP whose beneficiaries were the law firm's three attorney partners. For tax year ended Apr. 30, 2005, the law firm's only partners were the three attorneys.

For tax year ended Apr. 30, 2004, the three attorney partners each had a one-third capital interest and a 30-percent profits and loss interest in the law firm. The S corporation had a 10-

During the years in question Troy Renkemeyer (sometimes referred to as petitioner) was the tax matters partner of

THE SELF-EMPLOYMENT TAX DISPARITY

Provided that an S corporation pays reasonable compensation to its shareholder-employees, a shareholder-employee's pro-rata share of the S corporation's income is not subject to self-employment tax.[22] Thus, although the shareholder-employee is subject to employment taxes on compensation, other distributions and the shareholder's pro-rata share of the corporation's income are not subject to self-employment tax. In contrast, a general partner's allocable share of the partnership's income is subject to self-employment tax along with any guaranteed payments (i.e., payments made for services rendered by the partner to the partnership).[23]

Traditionally, under IRC § 1402(a)(13), a limited partner's allocable share of the partnership's income was not subject to self-employment tax though any guaranteed payments received by the partner were.[24] As discussed below, the U.S. Tax Court's decision in *Renkemeyer* overturns this distinction in certain cases. The self-employment tax consequences of membership in an LLC taxed as a partnership are less clear, although many commentators suggest that non-manager members, like limited partners, are not subject to self-employment taxes on their allocable share of the LLC's income, while manager-members may be treated more like general partners.[25] *Renkemeyer* likely impacts this distinction as well in the case of active members.

For obvious reasons, the self-employment tax disparity has long favored S corporations as the entity of choice for self-employment tax purposes. The 2013 imposition of the 0.9% AMCT on earned income only serves to broaden the gap.

THE RENKEMEYER DECISION

In *Renkemeyer*, the U.S. Tax Court held that IRC § 1402(a)(13), which generally provides that a limited partner's allocable share of the partnership's income is exempt from self-employment tax, does not apply to limited partners who actively provide services to the partnership.[26] According to the U.S. Tax Court, the legislative history of IRC § 1402(a)(13) indicates that *only* income of an investment nature was intended to be excluded from a limited partner's self-employment income.[27] As a result, the court concluded that self-employment income includes a limited partner's allocable share of partnership income in cases in which the partner performs services for the partnership (i.e., acts in the manner of a self-employed person).[28]

Renkemeyer involved a law firm organized as a limited liability partnership in Kansas.[29] Each of the firm's lawyers owned a limited partnership interest in the firm and provided legal services to the partnership that generated the firm's business income.[30] Although the law firm reported the business revenues from its practice on its partnership income tax return, no portion of those revenues were treated as self-employment income by the firm's partners.[31] As a result of the U.S. Tax Court's decision, all of the firm's revenues were subject to self-employment tax.

Assuming that *Renkemeyer* is upheld on appeal, the self-employment tax landscape for limited partners who provide services to the partnership will change significantly. Although *Renkemeyer* dealt only with a Kansas limited liability partnership, most commentators concur that, if upheld, *Renkemeyer* also will be extended by the IRS to service provider members of LLCs.[32] When coupled with the new AMCT, the result is a marked increase in the taxes owed by active limited partners and, likely, active LLC members and a new reason to favor using S corporations in these cases.

As an illustration, the following table (*see top of pp. 20*) summarizes the various taxes imposed on the income received by an active, service-provider owner of a partnership,

The Active Owner Post *Renkemeyer*

INCOME ITEM	TYPE OF PASS-THROUGH ENTITY OWNER			
	S SHAREHOLDER	LLC MEMBER	LIMITED PARTNER	GENERAL PARTNER
Compensation or Guaranteed Payment	E + 0.9% AMCT	SE + 0.9% AMCT	SE + 0.9% AMCT	SE + 0.9% AMCT
Entity Distributions (In Excess of Basis)	3.8% NII	3.8% NII	3.8% NII	3.8% NII
Allocable Share of Entity Non-Investment Income[33]	N/A	SE + 0.9% AMCT (Perhaps)	SE + 0.9% AMCT	SE + 0.9% AMCT

LLC, and S corporation in 2013. For purposes of the chart, "E" denotes the 7.65% combined employee-side federal employment tax rate and "SE" denotes the combined 15.3% self-employment tax rate.

As shown above, the use of an S corporation eliminates the imposition of self-employment tax and AMCT on an active shareholder's pro-rata share of the S corporation's income, provided that the compensation subject to employment tax in box 1 is "reasonable." The same benefit does not apply to limited partners, general partners, and likely LLC members if *Renkemeyer* is extended with respect to those owner's allocable share of the entity's income.

In contrast, as illustrated by the table below, in cases involving a passive owner who does not provide services to the entity, the use of an S corporation is tax neutral for self-employment tax and AMCT purposes. The chart below assumes that the investment in the entity is a "passive activity" with respect to each type of owner under IRC § 469.

In sum, the AMCT and NII surtaxes though small must be considered in business and investment decisions in 2013 and future years. These new taxes augment the benefit of using an S corporation in cases involving active, service-oriented owners due to the fact that self-employment taxes, including AMCT, can be avoided. abl

The Passive Owner Post *Renkemeyer*

INCOME ITEM	TYPE OF PASS-THROUGH ENTITY OWNER			
	S SHAREHOLDER	LLC MEMBER	LIMITED PARTNER	GENERAL PARTNER
Compensation or Guaranteed Payment	N/A	N/A	N/A	N/A
Entity Distributions (In Excess of Basis)	3.8% NII	3.8% NII	3.8% NII	3.8% NII
Allocable Share of Entity Non-Investment Income[34]	3.8% NII	3.8% NII	3.8% NII	3.8% NII

ENDNOTES

1. *National Federation of Independent Business (NFIB) v. Sebelius*, 2012-2 U.S.T.C. ¶50,573.
2. The term S corporation should be considered to include any eligible busines entity described in 26 CFR Ch. 1 § 330.7701-2(b) (1), (3), (4), (5), (6), (7) or (8) that elects to be treated as an S-corporation under § 301.7701-3 including, without limitation, limited liability companies
3. The term limited liability company should be considered to include only those LLCs that choose not to be treated as S elected entities under the Code.
4. *See generally* IRC § 3101 (tax on employees). Employers also pay Social Security tax at a rate of 6.2% on the first $113,700 of wages paid to each employee in 2013 and Medicare tax at a rate of 1.45%. However, as noted below, employers are not liable for AMCT.
5. *See generally* IRC § 1401 (self-employment tax).
6. Proposed Treasury Regulation ("*Prop. Treas. Reg.*") § 31.3101-2(b)(2).
7. Prop. Treas. Reg. § 31.3102-4(a).
8. *Id.*
9. Prop. Treas. Reg. § 31.3102-4(b).
10. Prop. Treas. Reg. §§ 1.401-1(b) and 1.1401-1(d).
11. Prop. Treas. Reg. § 1.1401-1(d)(2)(ii).
12. IRC § 1411(a) and (b).
13. IRC § 1411(d).
14. IRC § 1411(c)(1) and (2).
15. Prop. Treas. Reg. §§ 1.1441-1(b) and (d)(3)(ii). Prop. Treas. Reg. § 1.1411-4(b)(2). If items of NII pass-through to a partner or S corporation shareholder, the pass-through entity must separately report those items on Schedule K-1.
16. *Id.* In the case of a rental activity, the activity is generally characterized as passive unless the owner is a real estate professional who materially participates in the rental activity.
17. Prop. Treas. Reg. § 1.1411-4(b)(3), Example 3.
18. Prop. Treas. Reg. § 1.1411-4(b)(2).
19. IRC § 1411(c)(1).
20. Prop. Treas. Reg. § 1.1411-14(f)(1)(ii).
21. Prop. Treas. Reg. §§ 1.1411-4(f), (3)(i) and (3)(ii).
22. Rev. Rul. 59-291, 1959-1 C.B. 255, and *Ding v. Comm'r*, 200 F.3d 587 (9th Cir. 1999).
23. IRC § 1402(a).
24. IRC § 1402(a)(13) provides that self-employment income excludes "the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in section 707(c) to that partner for services actually rendered to or on behalf of the partnership …."
25. *See, e.g.*, Donald Cunningham and Paul Erickson, *Self-Employment Taxes and the Entity Choice Decision for Owners of Closely Held Firms, Business Entities* (WG&L), Jul/Aug 2004.
26. 136 T.C. at 150.
27. Id.
28. Id.
29. Id. at 138.
30. Id.
31. Id. at 140.
32. *See, e.g.*, W. Eugene Seago, Kenneth N. Orbach, and Edward J. Schnee, *Working With the Unearned Income Medicare Tax*, Journal of Taxation, Mar. 2103.
33. Note that items characterized as investment income at the entity level will retain that character at the owner level and will be subject to the 3.8% NII if the owner's income exceeds the applicable threshold.
34. Since each type of owner is assumed to be "passive" with respect to the entity, the trade or business income of the entity becomes category two investment income at the owner level for NII purposes.

ABOUT THE AUTHORS

KELLY C. MOONEY, J.D., L.L.M. (Taxation) is a shareholder in the Tax Department at Gallagher & Kennedy, P.A., in Phoenix, Arizona. She practices in the area of federal tax law, with an emphasis on the taxation of individuals, corporations, partnerships, tax-exempt entities, and civil tax controversy matters.

TIMOTHY D. BROWN, J.D. is the director of the Tax Department at Gallagher & Kennedy, P.A., in Phoenix, Arizona. He practices in all areas of federal tax law, with an emphasis on real estate, partnerships, limited liability companies, corporations, and civil tax controversy. In 2007-2014, he was listed as one of "The Best Lawyers in America" by Woodward/White, Inc.