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New Health Care Funding Taxes
The Impact on Business Owners
By Ted Kurlowicz, JD, LLM, CLU®, ChFC®, CAP®, AEP

Tax burdens to help fund Obamacare are now in effect for business owners.

THE FEDERAL INCOME TAX treatment of business income for both the business and its owner is a complex topic. Tax minimization, of course, is an extremely important goal when selecting the form of business entity and determining the type of operations. This article is not a comprehensive discussion of income taxes but focuses on the impact on business owners of two
new tax provisions provided by the Affordable Care Act of 2010 (ACA). With limited exceptions, only a C corporation is a separate taxpayer. In this instance, the business’s net income is taxable at corporate rates and does not have an immediate impact on the corporation’s shareholders. In the case of a closely held corporation, many or all of the shareholders will also be treated as statutory employees. For proprietorships, partnerships (including LLCs) and S corporations (greater than 2-percent shareholders), the owners of the business will be treated as self-employed. All income of such pass-through entities is taxed directly to the owners.

Two tax burdens were enacted to partially fund the ACA and took effect beginning with 2013 income. The 2013 tax preparation will be the first time business owners will see the burden of these taxes.

**ADDITIONAL MEDICARE TAX**
The first ACA funding provision affects earned income from self-employment and wages for statutory employees. An additional .9 percent Medicare tax was imposed on earned income for higher earners. No additional tax is imposed on the employer. Essentially, this makes the Medicare tax 3.8 percent for earned income over the threshold, without a ceiling on earnings. For stockholder-employees of a regular corporation, this would apply to wages above a threshold amount (provided in the table). For owners of pass-through entities, this would apply to self-employment income over the threshold amount. Because the threshold amounts are not indexed for inflation, more and more taxpayers will be affected as time goes on. The business has a compliance burden to withhold the tax for earnings above $200,000. The business only considers the employee’s income and not that of his or her spouse. Adjustments for over- or under-withholding would be made on the individual tax return.

**TAX ON NET INVESTMENT INCOME**
The ACA imposes a 3.8 percent tax (Medicare contribution tax) on net investment income (NII) for taxpayers above the threshold amounts, which are identical to the thresholds for the .9 percent additional Medicare tax. The key to understanding the impact of this tax on business owners is the definition of items included (or excluded) from the definition of NII. For this purpose, NII includes:

- Interest
- Dividends
- Annuities
- Royalties
- Rents (Note: exception for self-rented property discussed later)
- Gains (Note: exception for gains on property held in a trade or business that is not a passive activity)

Items that are excluded from the definition of NII include:

- Trade or business income
- Income treated as self-employment income
- Sale of a partnership, LLC or S corporation by an active participant
- Distributions from IRAs and qualified plans
- Build-up amounts in life insurance and deferred annuities
- Income tax exempt under the Internal Revenue Code
- Charitable trusts

<table>
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<th>Threshold Earning Amounts for the New Affordable Care Act Provisions</th>
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<td><strong>Married filing jointly</strong></td>
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<tr>
<td><strong>Single taxpayer</strong></td>
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<td><strong>Married filing separately</strong></td>
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The 3.8 percent tax applies to the lesser of the NII or the taxpayer’s MAGI in excess of the applicable threshold amount, for example:

A shareholder-employee of a closely held corporation (filing status: single) had $400,000 in wages, $150,000 in dividend income and MAGI of $550,000 in 2013. The taxpayer would be liable for $1,800 in additional Medicare tax on his or her wages ($400,000 wages - $200,000 threshold amount, multiplied by .9 percent) and $5,700 on unearned income ($150,000 NII multiplied by 3.8 percent), for total additional taxes of $7,500.

There are many tax implications for a variety of business owners.

OWNERS OF A CLOSELY HELD CORPORATION
Because the closely held corporation is a separate taxpayer and shareholders who provide services can be treated as statutory employees, the tax treatment is fairly straightforward. Reasonable salaries are deductible by the corporation and create wage income for the employee. This income will be included in MAGI and subject to the additional .9 percent Medicare tax once the shareholder-employee is above the threshold. Dividends distributed to shareholders are NII and subject to the 3.8 percent tax for affected taxpayers. Gains from the sale of stock will be included in NII.

OWNERS OF PASS-THROUGH ENTITIES
For sole proprietors, partners, members of an LLC or S corporation shareholders, income that is treated as self-employment income is subject to the .9 percent additional Medicare tax but not the tax on NII, once the taxpayer reaches the MAGI threshold. There is a small caveat here: Some income items of the business, such as rental income, interest and gains or losses, might not meet the definition of self-employment income and will be treated as NII. Hence, income or gains on working capital of a pass-through could expose the pass-through owners to the tax on NII. For an S corporation and perhaps an LLC, not all income is necessarily treated as self-employment income. Certainly, wages to the shareholder-employee of an S corporation will be self-employment income. However, it is also possible to shift income to “passive” investors of the S corporation, and such income is a dividend or NII.

“Business owners are going to become painfully aware of these taxes when returns are filed this April 15.”
Sales of an interest in a pass-through should avoid the definition of NII if the seller was an active participant in the business. An exclusion from NII is provided by the statute and regulations for net gains on the sale of the interest as if the property were sold by the partnership, LLC or S corporation.

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SELF-RENTAL ACTIVITY
This article intentionally does not address the complex rules in the regulations concerning the potential treatment of a real estate investor to avoid the passive activity rules. However, the regulations address the issue of self-rental of real estate and provide an important exception for such rental income from NII. This is important because it is fairly typical for the owner of a closely held business entity to lease one or more buildings (owned personally or in a controlled entity) to his or her closely held business or professional practice. Rental income in such instances avoids the definition of NII if the taxpayer leses the building to a business in which the landlord materially participates. For example:

Tom operates his law practice in an S corporation. He personally owns a building that is leased to the S corporation. The net rental for the lease avoids the 3.8 percent Medicare contribution tax.

REAL ESTATE PROFESSIONALS
The treatment of rental income as NII is one of the more complex areas in this law. The final regulations address this and had to re-address the regulations under the passive activity rules, which have not been examined since the 1980s. Rental income will be exempt from treatment as NII if the taxpayer is either a real estate professional (who participates more than 500 hours in the activity or has participated in more than 500 hours in the activity for five of the last 10 years) or rental income is derived from an active trade or business (as described in IRC section 162). The final regulations are also quite flexible with respect to individuals who have multiple real estate activities. If the taxpayer has pieces of real estate and meets the active participation test with respect to some but not others, the activities can be grouped together, and the taxpayer will be treated as meeting the material participation requirement with respect to all real estate activities in the group. Beginning in 2014, a one-time regrouping of activities can occur in the first taxable year that the taxpayer would be subject to tax on NII.

SELECTED STRATEGIES FOR AVOIDING THE TAX ON NII
Many possibilities exist for mitigating the impact of the 3.8 percent tax on NII. Each business owner’s position is unique and strategies will involve complex planning and implementation, such as the following:

- Rebalance portfolios to favor investment in assets that do not produce NII, such as municipal bonds, rental real estate (that meets the real estate professional definition), permanent life insurance and deferred annuities.
- Maximize contributions to qualified retirement plans and IRAs.
- Give consideration to a Roth IRA conversion.
- Make gifts of business interests to family members: Shift income to junior generation family members and reduce the senior generation’s MAGI. Shift passive income to family members under the income threshold.
- Make or increase charitable contributions to reduce the business owner’s MAGI and shift NII to a nontaxable charity.

The new taxes enacted to partially fund the ACA are little known and much more complex than they first appear. Audiences in professional groups have seemed somewhat shocked when I’ve presented my analysis of these taxes. Business owners are going to become painfully aware of these taxes when returns are filed this April 15. Hopefully, this article provides a quick introduction to the implications for planning to mitigate these taxes.