

**The Road Ahead for the Medicare Contributions Tax:
Business Compensation Issues and
Distributions upon Ownership Changes**

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I. Compensation and Earning

A. Stock as Compensation

Employees who receive stock for compensation generally pay tax on the stock. However, if a corporation awards nonvested stock, the employee does not recognize compensation until the stock vests. Internal Revenue Code Section 83(b) provides an exception where the employee can elect to pay tax on the value of the stock at the date of the issuance provided the employee makes a Section 83(b) election within 30 days of the issuance. Usually a corporation will gross up the employee's salary to pay the employee's taxes on the value of the stock.

B. Deferred Compensation

Performance bonuses that are paid within 2 1/2 months after the year end are also used to motivate employees provided the compensation is reasonable. Further, such performance payment paid within the 2 1/2 month rule is an exception to the nonqualified deferred compensation plan rules in Internal Revenue Code Section 409A. In addition, a fixed payment upon attaining a particular age also satisfies an exception to the nonqualified deferred compensation rules. For example, if there is a buyout of a senior employee as a part of a buy sell agreement and that employee receives \$100,000 a year payments beginning at age 65 for 10 years, receipt of this deferred compensation would not subject that employee to immediate taxation on the full amount. This exception would also apply when payment of the full amount of deferred compensation is triggered by an event such as a change in control of the business.

C. S Corporations and Partnerships

In a corporation with the S election, stock as compensation must vest immediately to maintain the one class of stock requirement. However, issuing non-voting stock does not create two classes of stock. This allows corporate management to vest the right to vote the stock over a period of time.

On the other hand, a partnership or a limited liability company (LLC) taxed as a partnership can award a profits interest to a partner which is similar to stock for compensation in a corporation. A profits interest is generally less expensive because it does not require a new partner to buy into any current business value. Under Rev. Proc. 93-27, if a person receives a profits interest the IRS generally will not treat such receipt of an interest as a taxable event to the partner. Profits interest can be non-voting.

D. Medicare Contribution Tax

Since stock for compensation and deferred compensation are considered earned income, these payments beginning in 2013 will not be subject to the Medicare Contribution Tax of 3.8% when the taxpayer modified adjusted income is in excess of \$200,000 (\$250,000 if married filing a joint return).

E. Withholding, FICA and Self Employment Taxes

C Corporations and S Corporations must withhold taxes and file quarterly forms 941 and annual forms W-2 for their employees. A partner's or an owner's compensation from partnerships, LLCs, and sole proprietorships does not involve withholding taxes and payroll taxes. Instead, partners and sole proprietors must file quarterly estimated taxes to pay their income taxes and self-employment taxes. Generally for sole proprietorships and most partnerships, their trade or business operating income is subject to both income tax and self-employment tax. Self-employment taxes are 13.3% on the taxable wage base, which for 2012 is \$110,100. Any amount over \$110,100 continues to be subject to the 2.9% tax on Medicare since it has no wage base limit like the one for social security. Sole proprietorships, partnerships and LLCs that engage in nontrade or nonbusiness activities or rental activities are generally not subject to self-employment tax. In addition, a limited partner's income is not subject to self employment tax except for guaranteed payments for services. The Internal Revenue Service defines a limited partner as a partner who has no personal liability for the partnership debts, has no authority to contract for the partnership, and does not participate in the trade or business more than 500 hours per year. In addition, there is a generally recognized exception for LLC members who do not participate in the management of the business and hold a second class of units such as preferred units for their capital interest. In all cases service members and service partners will be subject to self-employment tax.

For corporations, compensation, including distributions re-characterized as salaries, is subject to the social security tax and Medicare tax (FICA tax). For C Corporations, income that is retained by the corporation and not paid out as compensation is not subject to the FICA tax. For S Corporations, shareholders' health insurance and other fringe benefits are deductible by the S Corporation, but considered compensation to the shareholders. However, these fringe benefits are not subject to FICA tax unless the plan discriminates in favor of the owners. Only C Corporations can deduct benefits for dependent care, meals and lodging for the employer's convenience, and non-discriminatory premiums up to \$50,000 for group term life insurance.

If an owner leases property to his or her business and receives rental income or if an owner loans money to his or her business and receives interest income, the net rental income and interest income will be subject to the Medicare Contribution Tax of 3.8% starting in 2013. If the owner is over taxable wage base, then paying the 2.9% tax on Medicare may be a better alternative than net rental income and interest income. Also, beginning in 2013, the employee social security tax returns to its base of 6.2% instead of the current 4.2%.

II. Distribution upon Ownership Changes

A. Buy-Sell Agreements

A buy sell agreement is a contract among the owners or the owners and the entity

that provides for the sale of the owner's interest upon an event such as disability, retirement, or death. This is generally done with redemption agreements, cross purchase agreements, or perhaps an agreement that combines elements of redemption and cross purchase. These agreements determine the price and payment terms and restrict who can own interests of the business. In a LLC the buy sell agreement is normally included in the operating agreement and in a partnership the buy sell agreement is normally integrated into the partnership agreement. In a corporation, whether it is a C Corporation or an S Corporation, buy sell agreements are normally stand alone shareholder agreements.

Certain other events such as an owner's divorce or an owner's bankruptcy can trigger the buy sell provisions. In addition, some courts have held owners buy sell agreements not binding on spouses even if those spouses consented in writing to the buy sell agreement. However, such written consent generally prevents spouses from participating in the business and prevents spouses from leaving their community property interest in the business to a third party. To accomplish these objectives the buy sell agreement must specifically address these involuntary transfers. In any such situations, the capital gains will probably be subject to the Medicare Contribution tax of 3.8%.

B. Pre-Tax and After-Tax Income

Dividing a business or when one of the owners wishes to sell his or her share is typically handled through third-party financing, seller financing, and on occasion, through equity financing. When the buyer uses debt to pay for a business there are two layers of taxes imposed. The buyer must pay income tax on the earnings used to repay the debt. For partnership and S Corporation owners who are taxed on the income from operations using 40% for ordinary federal and state income tax rates, a business must earn \$167 of profits to fund the \$100 principal payments on the debt. For a C Corporation this structure is exacerbated if dividends are taxed at 15% and 5% at the state level. \$125 dividend generates \$100 after-tax. However to distribute \$125 to shareholders from a C Corporation that is subject to the tax on income from operations at 40% for federal and state capital gain/income tax rates the business must earn \$208 of income to be able to pay the \$125 dividend, which in turn funds the \$100 principal payment of the debt. On the other hand, since the seller pays tax on the sale using a combined 20% federal and state capital gain/income tax rate, the seller receives \$80 after taxes. What happens is that principal payments require somewhere between \$167 and \$208 of income to provide the seller with \$80 of after tax income. There are ways to make this more tax efficient. For example, perhaps the seller should lease some of the assets to the new owners, especially if assets like real estate are held outside of the business. With the 3.8% Medicare Contribution Tax, the seller will net \$76.20, not the \$80.00 in this example.

When a business entity acquires key employees and the seller's goodwill there are advantages to allocate some of the purchase price to a covenant not to compete and

goodwill. When goodwill is sold generally, the seller receives favorable capital gains treatment and the buyer deducts the payment over 15 years. For a covenant not to compete, the seller receives ordinary income treatment and the buyer deducts the payment over 15 years. Since the buyer receives an income tax deduction for the covenant not to compete although over 15 years the buyer is generally willing to pay a little more to the seller for such covenant. The seller will probably ask for a larger payment for the difference between the capital gain rate and ordinary income. At a 40% combined federal and state rate, the seller would need to receive \$133 to net \$80 of after tax income. If the capital gains rate of 20% for federal and state were used, the seller would need to receive \$100 to net \$80 of after tax income.

A Seller will probably pay the 3.8% Medicare Contribution Tax on the goodwill payments and it is not clear if the tax would apply to covenants not to compete payments.

In the past, another way to make the situation more tax efficient was to pay deferred compensation for past services. However, under the new nonqualified deferred compensation rules generally an owner must pay all the income taxes immediately in a lump sum unless a buy sell plan was already in place.