DEPARTMENT: TAX TIPS: HOW THE HEALTH CARE ACT AFFECTS THE TAXATION OF LOAN-OUT CORPORATIONS

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Text

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THE USE OF LOAN-OUT CORPORATIONS is prevalent in the entertainment industry. Some advisers prefer to use a C corporation as the loan-out corporation, while others prefer to use an S corporation. In both cases, the loan-out corporation would have a service contract with a third party, pursuant to which the loan-out corporation provides the services of a specified individual (typically the sole share-holder-employee) to that third party. These third-party contracts frequently provide for payments to the loan-out corporation that are defined in terms of profits. Those payments are often paid to the loan-out corporation even after the retirement or death of the share-holder-employee. In addition, the shareholder-employee frequently enters into an employment agreement with the loan-out corporation under which his or her estate would continue to be paid compensation by the loan-out corporation after his or her death. [1]

The 2010 Health Care Act imposed an additional 3.8 percent Medicare contribution tax on investment income. Additionally, the act increased the employee portion of the Medicare tax on compensation income by .9 percent to 2.35 percent.

There are at least five categories of payments that may be received by a loan-out corporation: 1) payments from film or television projects that have been released, aired, or syndicated, 2) payments from music projects for which the records have been released, [2] 3) payments from projects that are in production but not yet released or aired, 4) payments from projects that are developed during the life of the shareholder, and 5) payments from projects that are developed after the death of the shareholder.

Accordingly, when a loan-out corporation receives service payments from the entertainment companies, it would generally pay out a substantial portion of its income to its shareholder-employee in the form of compensation subject to employment taxes. Any remaining income would typically be distributed to the shareholder as a distribution that is intended to not be subject to employment taxes. The amount of compensation typically is higher in the case of C corporation loan-out corporations than in the case of S corporations, in order to reduce the combined corporate and individual level of income taxes.

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[1] Although most loan-out corporations are service corporations that only receive current and deferred compensation payments from third parties, some loan-out corporations own copyrights or other intangible assets and receive royalty payments in addition to compensation payments. The Medicare tax issues arising from these mixed-use loan-out corporations are more complex and merit separate analysis.

[2] Note that frequently, musicians receive payments that are titled as royalties, but which in fact are really deferred compensation for prior services. An analysis of whether a loan-out corporation owns copyrights is necessary to determine the character of the income and whether it is subject to § 1411.

Effective January 1, 2013, the 2010 Health Care Act [3] imposed an additional 3.8 percent Medicare contribution tax on investment income. [4] Additionally, the act increased the employee portion of the Medicare tax on compensation income by .9 percent to 2.35 percent. This new tax affects loan-out corporations in the entertainment industry, but certain planning strategies may be used to minimize the adverse tax implications.

Specifically, Section 1411(a)(1) of the act imposes a 3.8 percent Medicare contribution tax on the lesser of 1) ″net investment income″ or 2) the excess of modified adjusted gross income over $ 250,000 in the case of taxpayers filing a joint return and over $ 200,000 for other taxpayers, including single individuals. Net investment income includes gross income from interest, dividends, annuities, royalties, and rents but does not include any distributions from certain qualified retirement plans or arrangements. [5] However, gross income from interest, dividends, annuities, royalties, and rents is not subject to the new 3.8 percent Medicare contribution tax if it is ″derived in the ordinary course of a trade or business,″ and the trade of business 1) does not constitute a passive activity within the meaning of *IRC Section 469* with respect to the taxpayer and 2) does not constitute trading in financial instruments or commodities. [6]

The new 3.8 percent Medicare contribution tax on net investment income was enacted along with increases in the employee portion and self-employment portion of the Medicare insurance tax. [7] Pursuant to the act, the employee portion of the Medicare insurance tax increases by .9 percent from 1.45 percent to 2.35 percent on wages in excess of the threshold amount, and the self-employment Medicare insurance tax increases by .9 percent from 2.9 percent to 3.8 percent on wages in excess of the threshold amount. [8] Additionally, deductions are available for the 1.45 percent employer portion of employment taxes and the 1.45 percent portion of the self-employment taxes. [9]

Reasonable Compensation

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[3] The Health Care and Education Reconciliation Act of 2010 (P.L. 111-152).

[4] On November 30, 2012, the Treasury Department issued proposed regulations (REG-13057-11) that provide guidance under l.R.C. § 1411 for individuals, trusts, and estates.

[5] l.R.C. § 1411(a)(1), (a)(5). For purposes of § 1411(a)(5), qualified plans or arrangements are those described in l.R.C. §§ 401 (a), 403(a), 403(b), 408, 408A, or 457(b) (qualified pension, profit-sharing, and stock bonus plans; qualified annuity plans; annuities purchased by § 501(c)(3) organizations or public schools; individual retirement accounts; Roth individual retirement accounts; and eligible deferred compensation plans).

[6] I.R.C. § 1411(c)(2). Proposed Treasury regulations provide that the material participation rules of I.R.C. § 469 will apply for purposes of determining whether a taxpayer materially participates in an I.R.C. § 162 trade or business for purposes of determining whether such trade or business is described in I.R.C. § 1411(c)(2)(A). Prop. Treas. Reg. 1.1411-5(b); Preamble to Prop. Treas. Reg. 1.1411 (REG-130507-11). Also, I.R.C. § 469(c) defines passive activities as trade or business activities in which the taxpayer does not ″materially participate.″ A taxpayer is nor treated as materially participating in an activity unless his or her involvement in the operations of the activity is ″regular, continuous, and substantial.″

[7] The 2010 Health Care Act imposes increases on the Medicare insurance portion of both the Federal Insurance Contributions Act (FICA) and the Self-Employment Contributions Act (SECA) taxes effective for tax years beginning after December 31, 2012. But for the 2010 Health Care Act, employers and employees would have been subject to 1) an old age, survivors, and disability insurance (OASDI) tax of 6.2% of covered wages up to the taxable wage base ($ 110,100 in 2012) and 2) the hospital insurance or Medicare tax of 1.45% of all covered wages, for a maximum total employment tax rate of 7.65% (for the first $ 110,000 plus 1.45% on all remaining covered wages).

[8] Under the 2010 Health Care Act, the total Medicare taxes paid by both the employee and the employer will increase to 3.8% (the employee at 2.35% and the employer at 1.45%) on earnings that are in excess of the threshold amount. Consistent with this, the 2010 Health Care Act increased the Medicare tax portion of the self-employment tax by .9% from 2.9% to 3.8% on earnings that are in excess of the threshold amount. The threshold amount is $ 250,000 in the case of a joint return or surviving spouse, $ 125,000 in the case of a married individual filing a separate return, and $ 200,000 for single individuals. I.R.C. §§ 3101 (b)(2); 1401(b)(2).

[9] l.R.C. §§ 164(f), 1402(a)(12).

As pass-through entities, S corporations generally do not pay federal entity-level tax on their taxable income. [10] Instead, taxable income and other attributes are allocated among the shareholders, who report the items and pay the corresponding tax on their personal income tax returns. [11] This S corporation flow-through income has an employment tax advantage over sole proprietorships, partnerships, and LLCs, since the IRS has held in *Revenue Ruling 59-221* that a share-holder's share of S corporation net income is not treated as self-employment income. [12] Therefore, S corporation shareholder-employees are motivated to minimize their salary in favor of distributions, which are not subject to payroll or self-employment tax.

[*16] In light of these potential employment tax savings, the IRS has long challenged attempts by shareholder-employees to minimize compensation in favor of distributions. In Revenue Ruling 74-44, the IRS held that distributions that two sole shareholders of an electing S corporation arranged to receive instead of reasonable compensation for services they performed constituted wages that are subject to payroll taxes. [13] Also, there have been several court decisions on the subject of paying minimal salaries to S corporation shareholder-employees in order to minimize federal employment taxes. [14] These decisions make it clear that the IRS has the power to reclassify purported S corporation distributions as disguised wages when stated compensation payments are unreasonably low. Accordingly, if an S corporation shareholder provides services to the S corporation, he or she should receive an adequate or reasonable amount of compensation for these services.

In contrast, C corporations are taxed as separate entities for federal income tax purposes. Accordingly, income earned by a C corporation is normally taxed at the corporate level using the corporate income tax rates, and any distributions made to stockholders are taxed again at the stockholders' tax rates as dividends. Because of these two levels of tax, a C corporation may be a less desirable form of business than the other business entities (e.g., partnerships, sole proprietorships, LLCs, or S corporations [15]). Additionally, in order to maximize the double tax that C corporations incur, the IRS tends to argue that certain payments by C corporations are in fact disguised dividends, rather than compensation. In order to avoid double taxation, shareholders of C corporations are motivated to minimize their dividends in favor of compensation. However, the C corporation shareholder's compensation must be considered ″reasonable″ in order to prevent the IRS from reclassifying the income as dividends. Section 162 allows compensation to be deducted as an ″ordinary and necessary″ expense of doing business if the compensation is 1) ″reasonable in amount″ and 2) ″based on services actually rendered.″

Active Participant

If the shareholder-employee meets one of the material participation tests provided for in the Treasury regulations, that shareholder-employee would be viewed as actively participating in the S corporation's trade or business. Treasury regulations provide that an individual's activities will be considered to be regular, continuous, and substantial activity if any of the following seven tests is satisfied: 1) participation in the activity is for more than 500 hours during the tax year,

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[10] Under California law, an S corporation is subject to a 1.5% tax on the S corporation's net income (in addition to the tax imposed on the shareholders) whether or not the income is distributed. REV. & TAX CODE § 23802(b). The 1.5% California state tax is deductible at the federal level.

[11] I.R.C. § 1366.

[12] In Rev. Rul. 59-662, the IRS held that an S corporation's pass-through income does not constitute net earnings from self-employment to the shareholders for purposes of the self-employment tax. Consequently, neither a shareholder's distributive share of income passed through from the S corporation under l.R.C. § 1366 nor any S corporation distributions actually received by the shareholder from the S corporation constitute net earnings from self-employment subject to the self-employment tax.

[13] Rev. Rul. 74-44, 1974-1 CB 287.

[14] Radtke v. United States, 712 F. Supp. 143 (E.D. Wis. 1989) (The taxpayer was the sole shareholder and director of a law firm established as an S corporation, and the court found that the dividends that the taxpayer withdrew represented wages subject to payroll taxes.); Spicer Accounting Inc. v. United States, 918 F. 2d 90 (9th Cir. 1990) (The Ninth Circuit held that a taxpayer's service to his accounting firm, an S corporation, was substantial, noting that as the lone CPA in the firm, the taxpayer was the only person capable of signing tax returns, performing audits, and preparing letters, and that distributions paid to the taxpayer were classified properly as compensation subject to payroll taxes.).

[15] Note that in general, most entertainment companies will withhold payroll and income taxes from payments to LLCs or partnerships unless all the members or partners are corporations.

[16] 2) participation in the activity for the tax year constitutes substantially all of the participation in the activity by all individuals, including those who do not own interests in the activity, [17] 3) participation in the activity is for more than 100 hours during the tax year and the individual's participation in the activity for the tax year is not less than the participation in the activity of any other individual, including individuals who are not owners of interests in the activity, [18] 4) there is significant participation in the activity (generally 100 hours) for the tax year, and the individual's aggregate participation in all significant participation activities during the tax year exceeds 500 hours, [19] 5) there is material participation in the activity for any five tax years (whether or not consecutive) during the 10 tax years immediately preceding the tax year under consideration, [20] 6) there is material participation in a personal service activity in the field of health, law, engineering, architecture, accounting, actuarial science, performing arts, [21] consulting, or any other trade or business in which capital is not a material income-producing factor for any three tax years (whether or not consecutive) preceding the tax year under consideration, [22] or 7) based on all the facts and circumstances, participation in the activity is otherwise regular, continuous, and substantial during the tax year. [23]

Section 1411 Implications

If one of the above material participation tests is met, the income allocated by the S corporation loan-out to the shareholder-employee would not be subject to the additional Medicare contribution tax. However, the active trade or business exception does not apply to dividends paid by C corporations. Thus, any dividends paid by a C corporation loan-out corporation would be fully subject to the additional Medicare contribution tax.

Even after retirement, in many cases the loan-out corporation's shareholder-employee will continue to receive payments for his or her prior services after his or her retirement. The shareholder-employee could also receive payments from projects that are developed after retirement but during the life of the shareholder. If the shareholder-employee previously would have been considered a material participant in the loan-out corporation's trade or business, the shareholder-employee should continue to be eligible to receive compensation for those prior services under the deferred compensation provisions in the employment contract. The shareholder-employee's prior activity should continue to be considered ″regular, continuous, and substantial.″ Consequently, the deferred compensation the shareholder receives from an S corporation or C corporation loan-out should avoid the 3.8 percent Medicare contribution tax but instead be subject to the 2.35 percent employment tax. Furthermore, the income from the S corporation should also be considered active and thus not subject to the 3.8 percent Medicare contribution tax, while dividends from the C corporation, typically smaller in amount, would be subject to the 3.8 percent Medicare contribution tax.

When a shareholder-employee dies, the Section 1411 implications become more unclear. For trusts and estates, the new 3.8 percent Medicare contribution tax is imposed on the lesser of 1) undistributed net investment income or 2) the excess of a) adjusted gross income (as defined in *I.R.C. Section 67(e)*) over b) the dollar amount at which the highest trust-estate tax rate starts to apply (currently under $ 12,000). [24]

The shareholder-employee's estate may continue receiving salary payments from the loan-out corporation for prior services even after his or her death. The shareholder-employee would have been in a ″trade or business in which capital is not a

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[16] Treas. Reg. § 1.469-5T(a)(1).

[17] Treas. Reg. § 1.469-5T(a)(2).

[18] Treas. Reg. § 1.469-5T(a)(3).

[19] Treas. Reg. § 1.469-5T(a)(4) and (c).

[20] Treas. Reg. § 1.469-5T(a)(5).

[21] For these purposes, performing arts is defined to include the ″front of the camera″ actors and actresses, but not to include the ″behind the camera″ writers, producers, and directors.

[22] Treas. Reg. § 1.469-5T(a)(6).

[23] Treas. Reg. § 1.469-5T(a)(7).

[24] I.R.C. § 141 1(a)(2).

material income-production factor," and thus would have qualified as an active participant in the loan-out corporation's business in prior years. Presumably, the salary income the shareholder-employee, and ultimately the shareholder-employee's estate, receives from the loan-out corporation should continue to qualify as income that is not subject to the 3.8 percent Medicare contribution tax but instead is subject only to employment taxes. Although as a general rule it is often quite difficult for estates to qualify as materially participating in a trade or business, the absence of authority on this issue allows for the activity during the life of the decedent to be taken into account when determining the estate's activeness. Compensation received under the employment agreement from a C corporation loan-out would be subject only to employment taxes, while dividends would continue to be subject to the additional Medicare contribution tax.

If the decedent met one of the material participation tests provided by the Treasury regulations, most significantly the five-out-of-ten-years test, the estate could be viewed as actively participating in the loan-out corporation's trade or business. Accordingly, if the decedent was actively participating in any five years during the 10 tax years immediately preceding the tax year under consideration, the estate may be considered an active participant in the loan-out corporation's trade or business, and hence deferred compensation payable to the estate would not be subject to any Section 1411 Medicare contribution tax or any employment tax.

[*17] In cases in which the shareholder-employee performed the services and dies before receiving all the income, the salary income would be considered income in respect of a decedent (IRD). [25] Broadly speaking, IRD is money owed to a decedent at the time of death that would have been included in the decedent's gross income had the decedent lived to collect. [26] The fair market value of IRD must be included in the decedent's estate, subject to estate tax. In addition, stock of an S corporation attributable to IRD assets is not eligible for a basis step-up to fair market value on the date of the decedent's death, unlike other assets.

Retirement Plans and Deferred Compensation

Distributions from qualified retirement plans and qualified deferred compensation plans are not considered net investment income for purposes of the 3.8 percent Medicare contribution tax. [27] However, the distributions could be considered modified adjusted gross income. If the S corporation shareholder-employee dies without receiving the distributions, the distributions are IRD. The IRS also has ruled that proceeds of an individual retirement account (IRA) and qualified retirement plan benefits that were payable to the decedent's trust upon the decedent's death were considered to be IRD. [28]

The shareholder-employee should maximize his or her deductible contributions to IRAs, qualified retirement plans, and qualified deferred compensation plans. Additionally, when the estate receives plan distributions upon the death of the shareholder, those amounts will also be exempt from the 3.8 percent Medicare contribution tax, because distributions from certain qualified retirement plans or arrangements are **not** included in the definition of net investment income for purposes of Section 1411, [29]

With the enactment of Section 1411, an S corporation loan-out corporation is further incentivized to maximize paying out its income in the form of distributions rather than compensation during the shareholder's lifetime. When the shareholder-employee is an active participant in the S corporation's trade or business, distributions paid **out** to the shareholder during his or her lifetime will not be subject to the traditional employment taxes or the new 3.8 percent Medicare contribution tax. Rather, only reasonable compensation paid out to the shareholder-employee would be subject to the 2.35 percent employee portion of the Medicare insurance tax. Accordingly, with higher employment taxes beginning in 2013 and no Section 1411 Medicare tax on amounts flowing through to active S corporation shareholder-employees,

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[25] Additionally, there is no step-up in basis in the S corporation stock at the time of the shareholder's death.

[26] I.R.C. § 691(a)(l). *See also* Priv. Ltr. Rul. 200002011.

[27] I.R.C. § 1411(a)(5).

[28] Priv. Ltr. Rul. 9237020; Priv. Ltr. Rul. 9253038.

[29] *See supra* note 5 and accompanying text.

active S **[*18]** corporation shareholder-employees will have even more reasons to convert potential compensation amounts into S corporation income allocations and distributions. However, shareholders must make sure that the minimum compensation standard is met, so as to avert any challenges by the IRS.

In the case of shareholder-employees of C corporation loan-outs, the shareholder-employee will be paid substantially all of the corporation's pretax income as deductible compensation in order to reduce the possible double taxation of income. As a result, this type of corporation would distribute only a small dividend that would be subject to the additional Medicare contribution tax. The salary would be subject only to the additional employment income tax. These complex issues become even more so in the case of loan-out corporations that own copyrights and other intangible assets.