Income Tax Liability from Phantom Income

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Urgent message: How physician and entrepreneur investors structure their urgent care center may expose them to an income tax liability from phantom income, but there are steps they can take to ensure there are sufficient funds to cover it.

Introduction

Income taxes are one of life's certainties for most working Americans. Typically, however, income taxes are paid only on cash received during the course of a year. For example, a Form W-2 received by an employee summarizes the amount of wages that were paid to that employee during the year, similar to how a Form 1099-INT summarizes the amount of interest income that was paid to an individual during the course of the year (e.g., from a bank account). No one is surprised when their accountant tells them they owe taxes on these amounts.

However, there are circumstances where an individual may be required to report income on their U.S. individual income tax return (i.e., Form 1040) but where no corresponding cash was actually received by that individual. This income is commonly referred to as *phantom income* or *dry income*. Because of the way that many urgent care centers are organized, physicians and entrepreneurs who invest in centers are often caught by surprise when they are told they have an income tax liability resulting from phantom income.

Phantom Income

Phantom income generally arises when an urgent care center or other enterprise is organized as a pass-through entity, typically a limited liability company (LLC), some form of partnership (e.g., limited liability partnership [LLP]), or a subchapter S corporation (S corp). Although there may be some nuanced differences between different forms of entities, a discussion of which is beyond the scope of this article, the primary characteristic of a pass-through entity is that income generated by the entity is allocated (but not necessarily distributed) on the basis of a partner's, member's, or shareholder's ownership percentage in the entity.

Assume that an urgent care center is organized as a limited partnership of three owners: physician A, physician B, and investor C. Assume that physician A owns 50% of the center, and physician B and investor C each own 25%. At year end, the center reports a net profit of $1000 on its partnership return. However, instead of distributing the center's entire net profit to each owner in accordance with their pro rata ownership, the owners decide to reinvest in the business. In this example, the owners decide to make cash distributions totaling only $100, or 10% of the center's net profits, and use the remaining $900, or 90% of the center's net profits, to (1) prepay interest and principal on an outstanding bank loan and (2) modernize the center's office.

Thus, although physician A, physician B, and investor C receive only cash distributions of $50, $25, and $25, respectively, for income tax purposes, they are allocated a net profit of $500, $250, and $250, respectively. (The balance of the net profit not actually distributed will be added to each partner's capital [equity] account in the partnership. Thus, if the partnership were to dissolve, each partner would be entitled to receive liquidating proceeds of at least the value of their capital account, absent any liquidation preferences.) Each of the three owners would receive a Schedule K-1, which is the Internal Revenue Service (IRS) tax form that reports each partner's allocation of the partnership's net income. As a result, physician A would report $500 of income on her Form 1040 despite having received only $50 in cash, and physician B and investor C would each report $250 on their respective Form 1040 despite only having received $25 each in cash. Physician A will be taxed on $450 more income than she received in cash, and physician B and investor C will be taxed on $225 more income than each of them received in cash—hence, an income tax liability from phantom income.

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Each owner must pay income tax on the income that is allocated to them (whether or not any cash is actually distributed to them). Thus, assuming a marginal individual income tax rate of 30% per owner, physicians A and B and investor C will have an income tax liability of $150, $75, and $75, respectively. That means their individual income tax bill from owning the urgent care center will be three times the total amount of cash they received by virtue of their ownership. That is, they will have to come up with cash from other sources just to pay the income tax resulting from the phantom income.

The numbers used in this example are nominal, but the reality can be stark. Consider a center with $200,000 in net profits under the same facts: Physician A is left with a $30,000 tax bill that exceeds her cash distributions from the center by $20,000. An owner's income tax liability may be substantial and thus difficult to cover in a single payment to the IRS.

Preparing and Planning for Phantom Income

Owners and investors can guard against the unwelcome surprises associated with phantom income. Initially, they must identify whether the urgent care center is structured as a pass-through entity (including an S corp) or as a corporation that does not generate phantom income. Once they have determined that the center is a pass-through entity, they should analyze the center's financial statements, including a statement of cash flows, to understand how likely it is that the center will generate phantom income and, if it is likely, what the magnitude of the phantom income might be. Then they can at least establish procedures to track phantom income throughout the tax year and better plan for the potential tax liability. They may even be able to identify solutions to mitigate or eliminate the potential tax consequences. Here are some planning techniques and precautions.

Acquisition Due Diligence

Investors are well advised to seek the advice of a qualified tax professional before acquiring an ownership interest in an urgent care center. Prudent due diligence regarding the center's operations and financial statements may make clear whether the center is poised to generate a significant amount of phantom income, whether the center will generate a commensurate amount of cash that may be distributed, and whether it has cash-intensive expenses and balance sheet items (e.g., debt) or significant capital needs on the horizon.

Consideration of Cash-Intensive Expenses and Balance Sheet Items

Urgent care center investors and owners should analyze the company's statement of cash flows and sources and uses of cash. For example, an otherwise profitable center may have significant amounts of debt on its balance sheet. Though the interest portion of the debt service may be deductible and result in a lower net-profit figure that is ultimately allocated to the owners, the principal payments are not deductible and may be a significant cash drain on the business, creating an impediment to distribution of cash to the owner to cover their individual income tax liability.

Tax Distributions

It is common for owners of a pass-through entity to include a tax distribution provision in the entity's governing documents (e.g., LLC operating agreement). Although each tax distribution provision may have its own unique characteristics and mechanics, the overall purpose of such a provision is to cause the company to distribute a sufficient amount of cash to each owner to enable them to cover the income tax liability resulting from their allocation of the entity's income. Care must be taken when drafting such provisions to avoid unintended consequences (e.g., an owner receiving more cash from the entity than what that owner would otherwise be entitled to receive). Of course, for a tax distribution provision to serve its intended purpose, the entity must actually have cash to distribute. In some cases, the governing documents of an urgent care center may permit the center to borrow money in order to distribute a sufficient amount of cash to cover each owner's income tax liability.

Sound Cash Management and Creation of Reserve Accounts

To avoid an unwelcome surprise of a significant income tax liability for any owners, the owners and management should undertake sound cash-management procedures and consider establishing cash reserve accounts. Thus, the business can ensure, absent other contingencies or emergencies, that it has sufficient cash to distribute under a mandatory tax distribution provision, or that it is simply better positioned to distribute a greater percentage of its annual profit.

Production of Interim Financial Statements and Estimated Tax Payments

To avoid having to make a significant lump-sum income tax payment at the end of the year (and also to avoid potential estimated tax penalties), owners should make quarterly estimated tax payments that are based on the quarterly profit of the urgent care center. Interim (e.g., quarterly) financial statements may be used as a tool by tax advisors to help the owners calculate their quarterly estimated tax payment.

Conclusion

Physicians and other investors in an urgent care center must consider the legal form of the business to identify whether phantom income may be a relevant consideration. If phantom income is a possibility, the owners should investigate what steps they can take to mitigate the possibility of insufficient cash distributions to cover any tax liability. ■