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FALL 2023

Section 91A & Business Ownership: A Case Study

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Introduction

- Chapter 32 of Massachusetts General Laws contains several statutes that pertain to public retirees working after retirement.
- Focus today is on Section 91A - Disability Retirees, specifically those who own a business or corporation.
- Overview of Section 91A, PERAC's policies, and then review of a case study.

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Section 91A – Disability Retiree Limitations

- Disability retirees are limited on total earnings in a calendar year.
- The combined retirement allowance and total earnings in either public or private sector employment cannot exceed the regular compensation payable to such member had he or she continued
  in service in the grade held at retirement plus $15,000.
- Superannuation retirees are not limited in their earnings in the private sector.

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Section 91A – Statement of Earned Income

- Certifies the full amount of a member's earnings from earned income during the preceding year.
  - **840 CMR 10.16(4)**
    - "The term 'earnings from earned income' as used in G.L. c. 32, § 91A shall mean income that implies some labor, management or supervision in the production thereof.... "
- Must also submit all pertinent tax documents, such as:
  - ✓ W2
  - ✓ 1099
  - ✓ Form 1120-S
  - ✓ Schedule K-1
  - ✓ Schedule C

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Earned vs. Taxable Income

- **Earned income:** money derived from paid work that includes wages, commissions, bonuses, business income (minus expenses), and other taxable employee compensation.
  - Earned income does NOT include pensions and annuities, welfare benefits, unemployment benefits, workers' compensation benefits, or social security benefits.
- **Taxable income:** gross income minus deductions allowed by law that can be taxed, such as salary or wages, bonuses, unemployment benefits, prizes, winnings from gambling, and interest from back accounts.

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PERAC 91A Policy 19-001: Section 179 Deductions

- Section 179 of the Internal Revenue Code allows businesses to deduct the full purchase price of qualifying equipment and/or software purchased or financed during the tax year.
- PERAC will not include a full Section 179 Deduction in our excess earnings determination because while it is a tax benefit that ultimately lowers a member's taxable income, it has no effect on the earned income.
- PERAC will use the member's ordinary business income as reported on Line 1 of the Schedule K-1 (Line 21 of the 1120-S), or net profit amount reported on the Schedule C, C-EZ, or F when calculating their allowable earnings under Section 91A.

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PERAC 91A Policy 19-001: Section 179 Deductions *(Cont'd)*

- PERAC will, however, consider the reasonable annual cost of ownership or depreciation of capital assets when determining business profits.
- Where a member elects to take a Section 179 deduction, the member must provide PERAC with accounting information sufficient to support the reasonable annual cost of the business asset(s) being expensed.
- PERAC is entitled to disallow the Section 179 deduction in its excess earnings determination but must account for depreciation of a business asset when calculating excess earnings of a member whose "earnings from earned income" are derived at least in part from business profits.
  - ***Attleboro Contributory Ret. Bd. v. PERAC***, CR-16-83, (DALA Deb. 26, 2021) ("Dunn")

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PERAC 91A Policy 19-002: 50/50 Split

- For the purposes of determining a member's excess earnings pursuant to G.L. c. 32, § 91A, PERAC will consider the income derived from a business owned by the member's spouse or other immediate family member if there is evidence that the member is involved in the business.
- This policy applies regardless of how the business income is designated and regardless of the retiree's share of ownership or lack of ownership in the business.
  - ***West Springfield Ret. Bd. v. PERAC,*** CR-11-584 (May 20, 2019)
  - ***Frazier v. Barnstable County Ret. Bd.,*** CR-06-0190 (Dec. 23, 2008)

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PERAC 91A Policy 19-002: 50/50 Split *(Cont'd)*

- PERAC will start by assigning 50% of the reported ordinary business income to the member and 50% to the spouse or immediate family member where the member is involved in any business with their spouse or immediate family member.
- This is a rebuttable presumption, so if the facts and circumstances revealed during PERAC's investigation warrant a different division of business profits and compensation, the 50/50 split will change.

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Kim C. – A Case Study

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Meet Kim C.

- Age: 48
- Occupation: Librarian at the Halloweentown Public Library.
- Length of Service: 18 years from 2002-2020.
- Kim loved books so much, she opened her own book binding business, Skellington Books, in 2010 as a co-owner with her husband Kyle.
  - Kyle has worked part-time for the business as he also works full-time as an accountant.

➢ In 2020, Kim was injured at work and was approved for an accidental disability retirement benefit from the Halloweentown Retirement System.

➢ In 2020, after Kim was injured at work, her husband became the sole owner of Skellington Books.

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Kim C. – Statement of Earned Income

- In 2022, Kim diligently filed her 2021 Statement of Earned Income with PERAC, indicating on the Form that she worked for her husband's business.
- She included her W2 wages for Skellington Books, which totaled $10,000.
- She also included the Schedule K-1 and 1120-S for Skellington Books. Line 21 of the 1120-S showed an ordinary business income of $150,000.
- Skellington Books also claimed a Section 179 Deprecation for a new book binding machine that the business bought in 2021 for $50,000.

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Initial Calculation of Excess Earnings: 50/50 Split

- Retirement Allowance: **$50,000**
- Current Salary of Position Retired From: **$65,000**
- Allowable Earnings: $65,000 - $50,000 + $15,000 = **$30,000**
- Earned Income: **$85,000**
  - W2 wages: $10,000
  - Skellington Books 1120-S (Line 21): $150,000 / 2 = $75,000
- Section 179 – no depreciation schedule was provided for the book binding machine, so it was not included in the calculation.
- Excess Earnings Determination: $30,000 - $85,000 = **$55,000**

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Why Use the 50/50 Split Initially?

- **PERAC 91A Policy 19-002:** start at 50/50 and then adjust based on additional evidence.

Red Flags:

1) Kim was a 50% owner of Skellington Books until injury, then Kyle became 100% owner.
2) W2 wages were only $10,000, yet business had ordinary business income of $150,000 (meaning they made even more than that before expenses).

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Why Use the 50/50 Split Initially? *(Cont'd)*

- **Answers Needed:**

✓ How many hours did Kim work a week, on average? What were her job duties?

✓ How many hours did Kyle work a week, on average? What were his job duties?

✓ Why did Kyle assume 100% sole ownership of Skellington Books in 2020?

✓ Are there any other employees working for Skellington Books?

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Investigation

- Kim explained that her job duties in 2021 were the same as before her injury, which included calling clients, scheduling, hiring/firing, running the website, and repairing books.
- However, her hours did decrease from 25 hours a week to 18 hours a week after her work injury.
- Kyle continued working part-time for the business at 20 hours a week and his job duties included bookkeeping and repairing books.
- Upon request, Kim provided a 5-year depreciation schedule for the book binding machine and provided documentation that it was used exclusively for Skellington Books.

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Investigation *(Cont'd)*

- Kim confirmed that she has 2 other employees who worked part-time since 2015, roughly 15-20 hours a week, and helped call clients and repair books.
- Kim said that Kyle became sole owner of Skellington Books because she was not able to work as much since the injury.

Red Flags:

1) W2 wages of $10,000, but she worked 936 hours for the year = $10.68/hr
2) Kyle became sole owner but did not increase hours or workload.

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Final Calculation of Excess Earnings

- Originally, PERAC assessed excess earnings of **$55,000**, based on a 50/50 split of the ordinary business income of Skellington Books and Kim's W2 wages.
- Based on the updated information, PERAC would **NOT** change the 50/50 split determination.
- Kim is clearly working and generating profits for Skellington Books and her W2 wages do not adequately reflect the work that she is performing for the business.
- Also, it appears that the change of ownership was done to try and skirt the Section 91A earnings limitation.

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Final Calculation of Excess Earnings *(Cont'd)*

- However, a Section 179 depreciation schedule for the book binding machine was provided.
- Under Policy 19-001, PERAC will account for 20% of the cost of the machine to be subtracted from the ordinary business income.
  - $50,000 x .20 = $10,000
  - $150,000 - $10,000 = $140,000
- New Earned Income: **$80,000**
  - W2 wages: $10,000
  - Skellington Books 1120-S (Line 21): $140,000 / 2 = $70,000
- New Excess Earnings Determination: $30,000 - $80,000 = **$50,000**

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What if….?

- *What if Kim had said that she worked 10 hours a week and was now only responsible for calling clients, hiring/firing, and scheduling? But her husband still only worked part-time and had no change in job duties?*
  - 50/50 split would be changed to a 70/30 or 80/20 split.
  - Kim is doing decreased work and has decreased her hours - the W2 wages now seem to more adequately reflect the amount of work she is doing.
  - However, the ownership change was still only done to skirt the Section 91A earnings limitation.
  - Additionally, she still appears to be the face of the company as she remains the main person calling and interacting with clients.

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What if….?

- *What if Kim had said that she worked 10 hours a week and her job duties were only to repair book bindings? Kyle was now working full-time for the company and had taken most of the work calling clients, scheduling, bookkeeping, and hiring/firing.*
  - There would be **no split.**
  - All the ordinary business income for Skellington Books would be attributable to Kyle because the W2 wages clearly represent the limited work that Kim is doing for the business.
  - She no longer appears to be the face of Skellington Books and customers are now interacting with Kyle.

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Conclusion

- Retirement Boards should pay close attention to retirees who either own, partially own, or work for a family-owned business to determine whether they are providing “some labor, management or supervision” in the generation of profits for that business.
- **Key Question to Ask:**
  - ***How would this business fare without the retiree’s involvement?***
- If you or your retirees have questions, I can be reached at:
  - felicia.m.mcginniss@mass.gov
  - (617) 591-8909

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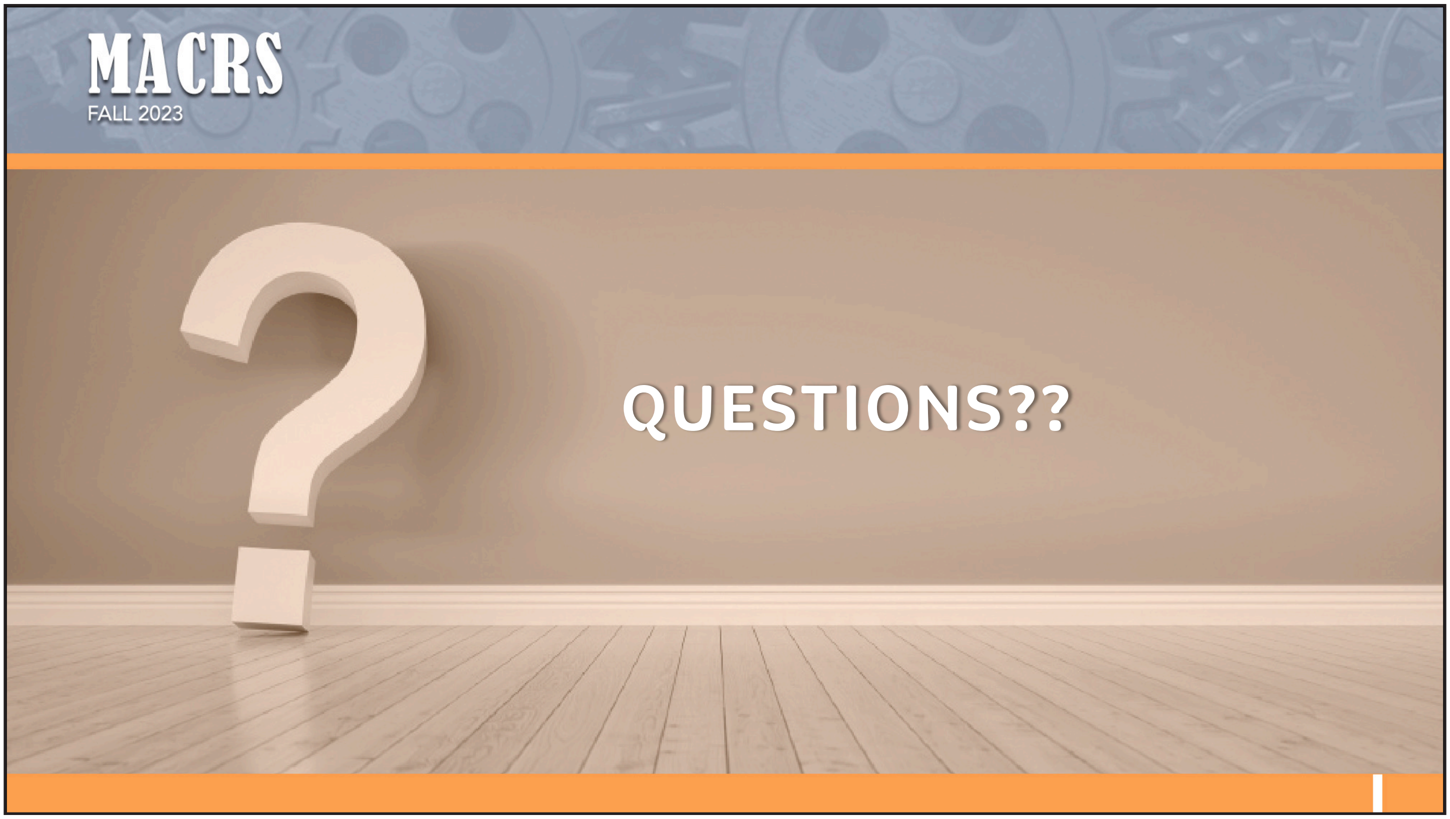

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Public Employee Retirement Administration Commission

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