pro@ctive™

To: Friends of Pro@ctive CPA
From: Mark Wyssbrod, Managing Member
Date: May 12, 2010
Re: Health Care Act of 2010

I hope all is well. It has been a volatile start to 2010 for most small businesses. We are currently in a time of good attitudes combined with increasing small business transactions. I urge you to take advantage of the current environment before summer vacations begin and another slow down occurs.

Below I will discuss some aspects of the Health Care Act of 2010 (the Health Care Act). I have read many summaries of the act and then re-read them since the end of tax season. I have included one of the summaries below. There are a lot of compliance costs including higher tax costs in the Health Care Act. When you take a step back and look at the big picture I see small businesses needing to substantially grow (revenues, margins and profits), merge or close there doors due to \ in order to absorb the higher costs of tax compliance and higher income taxes in the coming years.

One of the compliance issues will be enacted on January 1, 2012 and will require you to issue a 1099-MISC to basically everyone you write a check to or use a credit card with or transfer payment in any way. This will mean that you will need to have vendor files for all parties you conduct business with, track the payments by vendors and issue tax forms by January of the following year. For cash basis taxpayers this might cause a headache having to explain why revenue reported do not match 1099-MISC received each year (i.e. you may receive 1099-MISC for 200X even though you did not receive the payments and make the deposits well into January of the following year, but the check from the vendor is dated December 200X the vendor just waited a few weeks to mail it to you). The IRS may also take the stance to disallow deductions if you do not issue a 1099-MISC to a vendor (as they currently do with contact labor).

Another area of increase in compliance will effect payroll reporting. Your payroll service will need to greatly improve its quality and reporting. This translates into higher payroll service fees. Most payroll services cannot correctly report health insurance for S-corporation owners and soon will have to report a lot more information per employee. Good luck!

There are several sections of the Health Care Act which will be phased in during different years. I must warn you, please check with your doctor to see if ulcers are covered in your health plan before reading.

Sincerely,

Your Pro@ctive CPA Team

NEW CREDIT FOR SMALL EMPLOYERS PROVIDING EMPLOYEE HEALTH INSURANCE (Effective for tax years beginning after 2009). The *Health Care Act* provides an income tax credit for ***"eligible small employers" (ESEs)*** that **1)** offer health insurance to employees, **2)** pay at least 50% of cost of the insurance, and **3)** contribute a uniform percentage (at least 50%) of the premium cost for each employee who enrolls in the ESE's employee health plan. For **tax years beginning after 2009 and before 2014**, *the Health Care Act* provides a maximum credit of up to **35%** of the cost of qualifying employee health insurance. **For tax years beginning after 2013,** the maximum credit is **50%** of the employer's cost of qualifying employee health coverage. **Tax Tip.** Although in certain situations these rules can be quite technical and complicated, the IRS has begun an initiative to help small businesses determine if they qualify. For example, the IRS has mailed postcards to millions of small businesses encouraging them to take advantage of this credit if they qualify. The IRS has also recently added links to its main website (www.irs.gov) providing "tax tips," "guidance," and "answers to frequently asked questions" with respect to this credit. The following are several points clarifying this new credit:

1. **Only "*Eligible Small Employers*" Qualify For The Credit.** The credit is only available to an "eligible small employer" (ESE), whether formed as a regular "C" corporation, "S" corporation, partnership, LLC, or sole proprietorship. An ESE will generally receive **no credit if either 1)** it has **25 or more *full-time equivalent employees* (FTEs)** during the year, **or 2)** its **FTEs have *average annual wages* of $50,000 or more. The *number of FTEs*** is determined by dividing the total employee hours worked for the year (by all full-time and part-time employees) by 2,080 hours (i.e., the number of hours in a 52-week year based on a 40-hour work week). ***Average annual FTE wages*** are determined by dividing the employer's aggregate wages for the year by the number of FTEs. For purposes of each formula, there are special rules that may exclude hours worked by certain employees, or that may exclude the compensation paid to certain employees. For instance, the formulas ***exclude*** hours worked by and compensation paid to certain owners of the employer (and members of the owners' families), and *seasonal workers* (a worker who worked no more than 120 days during the tax year). **Planning Alert!** There are also special rules for aggregating employees who work within a controlled group of employers (e.g., multiple businesses with common ownership).

   Example. Let's assume that in 2010 an S corporation: employs 8 full-time employees (each worked 2,000 hours for the year); employs 4 part-time employees (each worked 500 hours for the year and worked on more than 120 days); and has total payroll for the year of $192,000. Excluding the owner and members of the owner's family, the S corporation has *8 FTEs* computed as follows: 8 full-time employees x 2,000 hours = 16,000 hours, plus 4 part-time employees x 500 hours = 2,000 hours, for a total of 18,000 hours divided by 2,080 = 8.65, rounded down to the next lowest whole number of 8. The *average annual FTE wages* would be $24,000 computed as follows: total annual payroll of $192,000 (excluding the owner and members of the owner's family) divided by 8 FTEs = $24,000. **Conclusion.** The S corporation would be an *Eligible Small Employer* (ESE) qualifying for the credit because it has fewer than 25 FTEs (it has 8) and the FTE's annual wages are less than $50,000 (FTE wages are $24,000). **Planning Alert!** The IRS website (www.irs.gov) has a link to "Health Care Tax Credit" which provides a guide entitled "3 Simple Steps," that helps in determining if a business qualifies for this credit.

2. **Credit Starts At 35%, But Is Reduced If FTEs Are More Than 10 Or FTE Wages Are More Than $25,000.** For tax years **beginning in 2010 through 2013,** the credit can be as high as 35% of the employer's qualifying health insurance premium costs. For tax years beginning in 2014 and 2015, the credit can be as high as 50%. For instance, let's assume in the previous example that the S corporation (*ESE)* paid qualifying health insurance premiums in 2010 of $60,000 for employees (excluding the owner and the owner's family members). The S corporation would be entitled to a credit of $21,000 ($60,000 x 35%). **Tax Tip.** Even though the *Health Care Act* was not signed into law until March 30, 2010, the IRS says that the credit can be taken on all qualifying premiums for the employer's tax year beginning in 2010 (e.g., for a calendar-year business, premiums paid as early as January 1, 2010 would qualify). The credit is taken on the employer's annual income tax return.

   The credit percentage is reduced pro rata as the number of FTEs go from 10 to 25 and/or as FTE wages go from $25,000 to $50,000. Thus, the **full amount of the credit** is available only to an employer **with 10 or fewer *FTEs*** whose **average FTE wages are $25,000 or less.** On the other hand, **the credit is phased out altogether if the employer has at least 25 *FTEs or* if it's average *FTE* wage amount is at least $50,000.** The credit rate, once determined, is generally applied to *the lesser of*: **1)** the cost of the employer's health insurance premiums, or **2)** an amount the HHS Secretary determines is the average premium for the small group

market for the area in which th employer is located (IRS says that it plans to post these on a State-by-State basis on the IRS website by the end of April, 2010).

3. **Credit Reduces Employer's Deduction For Health Insurance.** The credit reduces the amount of an employer's deduction for health insurance premiums. For example, if an employer's effective marginal income tax rate (state and federal) is 40% and the employer qualifies for a 35% health insurance credit, the net tax benefit will generally be only 21% (i.e., 35% x 60%) of the qualifying insurance premiums.

4. **Credit Not Available For Owners Or Members Of Owner's Family.** The credit is not allowed for health insurance premiums paid for partners, sole proprietors, more than 2% shareholders of an S corporation, more than 5% owners of a regular C corporation, or certain family members of the foregoing owners. Also, any wages paid to these individuals are excluded for determining the number of FTEs and the amount of average annual wages.

5. **No Credit For Domestic Employees.** A qualifying employee does not include domestic employees.

6. **Refundable Credit Available For Tax-Exempts.** A tax-exempt organization that satisfies the above requirements to be an "eligible small employer" and therefore, otherwise qualifies for the credit, can qualify for a *refundable* credit equal to the **lesser of 1) 25%** (instead of 35%) **of the health insurance premiums paid for qualifying employees** for **2010 through 2013** [for 2014 and 2015, the credit rate for tax exempts will be 35% (rather than 50%)], **or 2)** the sum of **a)** the employees' withheld income taxes, **b)** the Medicare taxes withheld from the employee's wages, and **c) the** employer's share of the Medicare taxes paid on the employees' wages. **Tax Tip.** The IRS says that it will be providing information in the future as to how a tax-exempt employer will actually claim this credit.

7. **Credit Reduces AMT.** The credit is allowed against the alternative minimum tax (AMT).

8. **Carryover And Carryback Of Unused Credits.** Any unused credit can generally be carried back one year and carried forward for up to twenty years. **Planning Alert!** Since this credit is not effective until 2010, any **unused credit for 2010** can only be carried forward, it cannot be carried back to 2009.

ADOPTION CREDIT INCREASED AND MADE REFUNDABLE AND EXCLUSION FOR EMPLOYER ADOPTION ASSISTANCE INCREASED (Effective For tax years beginning after 2009 and before 2012). For tax years beginning after 2009 and before 2012, the *Health Care Act* makes two significant changes to the adoption credit: **1)** the maximum adoption tax credit is **increased from $12,170 to $13,170 for 2010 and 2011** (an inflation adjustment will apply for 2011), **and 2)** the credit is *"refundable"* for 2010 and 2011, if the credit exceeds an individual's tax. **For 2010**, the adoption credit is phased-out as an individual's modified adjusted gross income increases from **$182,520 to $222,520** regardless of an individual's filing status (these are the same phase-out thresholds as under prior law). **Planning Alert!** As under prior law, married Individuals are not allowed to take the credit unless they file a joint return.

In addition, the Health Care Act increases the exclusion for employer-provided adoption assistance to the same dollar amounts as the credit (i.e., from $12,170 to $13,170 for 2010).

TAX-FREE MEDICAL BENEFITS EXTENDED TO CERTAIN CHILDREN THAT ARE NOT DEPENDENTS. There are several provisions in the *Health Care Act* dealing with the provisions of health care benefits for adult children.

1. **Medical Reimbursement Plans, Etc. (Effective March 30, 2010).** Effective March 30, 2010, the Health Care Act allows **tax-free reimbursements of medical expenses** from an employer-provided health plan (e.g., a medical reimbursement plan) to any child of the employee **who is not age 27** *as of the end of the tax year*. This exclusion applies even if the taxpayer cannot claim the child as a dependent for tax purposes. **Prior to this change,** tax-free reimbursements were only allowed for **dependent children.** Congress says this exclusion for children under age 27 also applies to the value of employer provided health insurance coverage provided to a child.

2. **Health Insurance Premium Deduction For Self Employed Individuals (Effective March 30, 2010).** Prior to the Act, self-employed individuals were allowed a "for AGI" deduction for premiums for health insurance that covered the self-employed individual, the individual's spouse, and the individual's dependents. Effective March 30, 2010, self-employed individuals may take a "for AGI" deduction for health insurance premiums where the insurance covers the **self-employed individual**, the individual's **spouse,** the individual's **dependents**, **and** the individual's **children who have not attained age 27** as of the end of the tax year.

3. **Retiree Health Benefits And VEBA Benefits Are Available To Children Under Age 27 (Effective March 30, 2010).** The Health Care Act allows sickness, accident, hospitalization, and medical expenses to be provided under a qualified pension or annuity plan (§401(h)) for the children of retired employees under age 27 at the end of the year, as well as for retired employees, their spouses and their dependents. In addition, the Health Care Act allows a voluntary employees' beneficiary association (VEBA-See §501(c)(9)), to pay the expenses of the VEBA member's child who has not attained age 27 by the end of the calendar year.

4. **Group Health Plans Covering Dependents Must Cover Children Under Age 26 (Effective for plan years beginning after September 22, 2010).** The Health Care Act requires that group health plans that cover dependent children must continue to make dependent coverage available for an adult child until the child reaches age 26. There is no requirement for a plan or issuer to provide health insurance coverage for anyone, including dependents. But if coverage is provided for dependent children, then, under the 2010 Health Care Act, the coverage must continue until the children turn 26. **Observation!** It is unclear why this provision applies to children under age 26 and the other three provisions mentioned above apply to children under age 27.

NEW 10% EXCISE TAX ON INDOOR TANNING SERVICES (Effective for services performed after June 30, 2010). The *Health Care Act* imposes a new 10% excise tax on customers of indoor tanning salons, for services performed after June 30, 2010. The tax is imposed on the full amount of the charge for the service and is imposed regardless of who pays the ultimate cost of the service, whether insurance or otherwise. Although the tax is imposed on the patron of the indoor tanning salon, like a retail sales tax, the salon will actually be required to collect the tax and pay it over to the IRS. This excise tax will not apply to phototherapy services performed by licensed medical professionals. **Planning Alert!** The IRS says that it will be issuing guidance in the near future on how tanning salons are to report and pay this tax.

HEALTH BENEFITS PROVIDED BY INDIAN TRIBAL GOVERNMENTS EXCLUDED FROM INCOME (Effective for benefits and coverage provided after March 23, 2010). Prior to the Health Care Act, there was no gross income exclusion for health benefits provided by Indian tribal governments. Effective after March 23, 2010, the Health Care Act generally provides an exclusion from gross income for health benefits provided by Indian tribal governments.

NEW REQUIREMENTS FOR HOSPITALS TO CONTINUE THEIR EXEMPT STATUS UNDER §501(c)(3) (Effective for tax years beginning after March 23, 2010). For tax years beginning after March 23, 2010, new qualification requirements apply to any §501(c)(3) organization that operates at least one hospital. To retain tax exempt status: **1)** A hospital must conduct a community health needs assessment at least once every three tax years and adopt an implementation strategy to meet the community needs identified through the assessment. For failures occurring after March 23, 2010, an **excise tax of $50,000** applies if a tax-exempt charitable hospital organization fails to complete a community health needs assessment in any applicable three-year period. **2)** A hospital must adopt, implement, and widely publicize a written financial assistance policy. The financial assistance policy must indicate the eligibility criteria for financial assistance and whether such assistance includes free or discounted care. **3)** A hospital must adopt and implement a policy to provide emergency medical treatment to individuals which prevents discrimination in the provision of emergency medical treatment. **4)** A Hospital must not bill for emergency or other medically necessary care provided to individuals who qualify for financial assistance under the facility's financial assistance policy more than the amounts generally billed to individuals who have insurance covering such care. **5)** A hospital cannot undertake extraordinary collection actions (even if otherwise permitted by law) against an individual without first making reasonable efforts to determine whether the individual is eligible for assistance under the hospital's financial assistance policy. **6)** Lastly, a hospital must file with its annual Form 990 a copy of its audited financial statements.

CODIFICATION OF ECONOMIC SUBSTANCE DOCTRINE (Effective for transactions entered into after March 30, 2010). For transactions entered into after March 30, 2010 and for underpayments, understatements, and refunds and credits attributable to transactions entered into after March 30, 2010, the Health Care Act clarifies application of the economic substance doctrine by providing a new uniform definition of economic substance. In the case of any transaction to which the economic substance doctrine is relevant, the

transaction is treated as having economic substance only if - apart from Federal income tax effects - **1)** the transaction **changes** in a meaningful way the **taxpayer's economic position**; **and 2)** the taxpayer **has a substantial purpose** for entering into such transaction. A transaction must satisfy both tests in order for it to be treated as having economic substance. **Note!** Any State or local income tax effect which is related to a Federal income tax effect is treated in the same manner as a Federal income tax effect.

In addition, for underpayments attributable to transactions entered into after March 30, 2010, a new penalty under §6662(b)(6) applies for an underpayment attributable to a transaction lacking economic substance. The penalty rate is 20% (increased to 40% if the taxpayer doesn't adequately disclose the transaction on the taxpayer's return or on a statement attached to the return). In addition, the reasonable cause and good faith exception doesn't apply to any portion of an underpayment which is attributable to a transaction lacking economic substance. The **economic substance doctrine is defined** as the common law doctrine under which tax benefits under subtitle A with respect to a transaction aren't allowed if the transaction doesn't have economic substance or lacks a business purpose. These new rules do not apply to personal transactions of individuals, only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income. For additional information, please see new §7701(o).

SELECTED PROVISIONS FIRST EFFECTIVE IN 2011

TAX-FREE REIMBURSEMENTS OF *OVER-THE-COUNTER* DRUGS (Effective for expenses incurred with respect to tax years beginning after 2010). Current law allows tax-free reimbursements for most *nonprescription* drugs and medicines from a health savings account (HSA), health flexible spending arrangement (FSA), health reimbursement arrangement (HRA), Archer medical savings account (MSA), or other qualified employer health plans. Effective for expenses incurred after 2010, reimbursements for drugs and medicines will be tax free *only for* a prescribed drug or insulin. Thus, over-the-counter medicines and drugs, other than insulin, will no longer qualify for tax-free reimbursement, unless prescribed by a physician. **Planning!** Presumably, we may continue to reimburse tax-free over-the-counter drugs and medicines if they are prescribed by a physician.

PENALTY FOR NON-QUALIFYING HSA OR MSA DISTRIBUTIONS INCREASED TO 20% (Effective for distributions after 2010). Generally, distributions for qualifying medical expenses from a *health savings account* (HSA) or *Archer Medical Saving Account* (MSA) are tax free. However under current law, distributions from an HSA prior to age 65 that are not for the reimbursement of qualifying medical expenses, are taxable, and are also subject to a 10% penalty (15% for an MSA). Effective for distributions from an HSA after 2010, the penalty for distributions made from an HSA prior to age 65 which are not used for qualified medical expenses is increased from 10% to 20% (for an MSA the increase is from 15% to 20%). **Planning Alert!** As discussed in the preceding paragraph, starting in 2011, HSA or MSA reimbursements for over-the-counter medications (other than insulin and over-the-counter medications prescribed by a physician) will be taxable. These reimbursements will also trigger a 20% penalty. **Tax Tip!** The penalty will not apply if the owner of the HSA or MSA is at least age 65 (i.e. eligible for medicare coverage) on the date of the distribution.

EMPLOYERS REQUIRED TO INCLUDE VALUE OF HEALTH INSURANCE ON W-2s (Effective for tax years beginning after 2010). For tax years beginning after 2010, employers will be required to report the annual aggregate cost of coverage under any group health plan provided to employees on the employee's Form W-2. This is only an information reporting requirement and will not change the tax-free treatment of employer-provided health coverage that exists under current law.

NEW *SIMPLE* CAFETERIA PLAN FOR SMALL EMPLOYERS (Effective for plan years beginning after 2010). Employer-sponsored cafeteria plans offer a menu of nontaxable benefits to participating employees. To qualify for this tax-favored status, cafeteria plans cannot discriminate in favor of highly-compensated participants or key employees. Smaller businesses sometimes find it difficult to justify providing a classic cafeteria plan to employees because the nondiscrimination requirements often diminish the benefits enjoyed by owner- employees. For plan years beginning after 2010, to encourage smaller employers to establish cafeteria plans, the *Health Care Act* creates a "simple cafeteria plan" that provides *eligible small employers* a safe harbor from the normal nondiscrimination requirements, if certain eligibility and participation rules are met. An **"eligible small employer"** is generally any employer that, during **either of the two preceding years, employed an average of 100 or fewer employees.** If an employer was not in existence throughout the preceding year, the employer may nonetheless be considered as an eligible employer if it reasonably expects to average 100 or fewer employees during the current year. **The minimum eligibility and participation requirements** are met with respect to any year if, under the plan, **1)** all employees who had at least 1,000 hours of service for the preceding plan year are eligible to participate, and **2)** each employee eligible to participate in the plan may, subject to terms and conditions applicable to all participants, elect any benefit available under the plan.

However, an employer may elect to exclude from coverage under the plan employees who **1)** have not attained the age of 21, **2)** have less than one year of service with the employer, **3)** are covered under a qualified collective bargaining agreement, or **4)** are nonresident aliens working outside the U.S.

ANNUAL FEE FOR BRANDED PRESCRIPTION PHARMACEUTICAL MANUFACTURERS AND IMPORTERS (Effective after 2010). For calendar years beginning after 2010, each entity engaged in the business of manufacturing or importing branded prescription drugs for sale to any specified government program or pursuant to coverage under any such program must pay an annual nondeductible fee, which will be credited to the Medicare Part B trust fund. The annual flat fee beginning in 2011 is allocated across the industry according to market share. The total fee to be allocated is: $2.5 billion for **2011**; $2.8 billion for **2012 and 2013**; $3 billion for **2014, 2015, and 2016**; $4 billion for **2017**; $4.1 billion for **2018**; **and** $2.8 billion for **2019 and later**.

SELECTED PROVISIONS FIRST EFFECTIVE IN 2012

1099s REQUIRED FOR PAYMENTS OVER $600 TO CORPORATIONS (Effective for payments after 2011). Generally, any business that makes payments of compensation, interest, rents, royalties, income, etc. aggregating $600 or more for the year to a single payee is required to report the payments to the IRS by filing a Form 1099. Under current law, this reporting requirement, subject to several exceptions, *does not apply to payments to a corporation*. Under the *Health Care Act*, **effective for payments made after 2011**, this new reporting rule will generally apply to payments aggregating $600 or more to corporations as well as others. However, reporting is not required for payments to tax-exempt corporations.

1099s REQUIRED FOR PAYMENTS OVER $600 MADE IN RETURN FOR PROPERTY (Effective for payments after 2011). After 2011, the Health Care Act requires 1099 reporting for payments made in consideration for property, by persons engaged in a trade or business, if the gross payments exceed $600. However, Congress points out that these rules do not override specific provisions elsewhere in the Code that exempt certain payments from 1099 reporting. **Example.** Tool Time, Inc. is engaged in the manufacture of tools. In 2012, Tool Time purchases a truck for use in its business from Al Borland for $25,000. Al's basis in the truck is $30,000. Tool Time will be required to file Form 1099 with the IRS reporting the $25,000 payment. Tool Time must also provide a copy of the Form 1099 to Al. **Observation!** The $25,000 payment must be reported on Form 1099 even though Al has a loss on the sale of the truck.

FEES ON HEALTH PLANS TO FINANCE RESEARCH (Effective for policy years ending after September 30, 2012). Generally, the Health Care Act imposes on each health insurance policy and on each applicable self-insured health plan for each policy year ending after September 30, 2012, a fee equal to the product of $2 ($1 for policy years ending during 2013) multiplied by the average number of lives covered under the policy. The issuer of the health insurance policy or the self-insured health plan sponsor is liable for and must pay the fee. The fee is to be used to finance the patient-centered outcomes research trust fund which will carry out the provisions of the Health Care Act relating to comparative clinical effectiveness research.

SELECTED PROVISIONS FIRST EFFECTIVE IN 2013

ADDITIONAL .9% MEDICARE SURTAX ON *EARNED INCOME* OF HIGHER-INCOME TAXPAYERS (Generally effective for amounts received after 2012). Under current law, the overall Medicare tax rate is 2.9% (1.45% imposed on the employee and an additional 1.45% imposed on the employer). Self-employed individuals must pay the entire 2.9% Medicare tax on their earned income. However, self-employed taxpayers are allowed to deduct one-half (1.45%) of their Medicare tax as an "above-the-line" deduction. Although the *Health Care Act* does not increase Social Security taxes, it does increase Medicare taxes for higher income taxpayers. Generally, **for wages and self-employed earnings received after 2012,** the *Health Care Act* imposes **an additional .9% Medicare Surtax.** The surtax applies to the amount by which the **sum of** an individual's **1)** *W-2 wages* **and 2)** *earnings* from self employment **exceeds $250,000** for individuals that are **married filing a joint return, $200,000 for single individuals, and $125,000 for married individuals filing separately. Note!** For married individuals filing a joint return, the **W-2 earnings and the self-employed earnings of both husband and wife are aggregated** in determining if the earnings exceed the $250,000 threshold. **The following are selected points concerning this new tax:**

1. **Tax Is Withheld By Employers But Employee Ultimately Liable For Tax.** This .9% increase in Medicare taxes will

technically be imposed on the employee. However, the employer will generally be required to withhold this additional tax from an employee's wages. Therefore, the Medicare tax rate on W-2 earnings in excess of $200,000 or $250,000 (if married) will be 2.35% (up from 1.45%). **For example**, let's assume that in 2013, Raymond, a single individual, is paid $300,000 in salary by his employer, Newsday. Raymond's share of the Medicare tax withheld from his wages would be $2,900 (1.45% on the first $200,000 of wages) plus an additional $2,350 (2.35% on the $100,000 of wages that exceeded $200,000). In addition, Newsday would pay the normal employer's share of Medicare tax of 1.45% of Raymond's entire wages of $300,000, or $4,350. **Note!** If Raymond worked for two employers rather than one and he received $150,000 of wages from each employer, neither employer would be required to withhold the .9% Medicare surtax, because Raymond's wages from neither employer alone exceed $200,000. However, Raymond would be liable for the .9% surtax on his individual income tax return. **Furthermore, let's assume that Raymond is married to Debra and they file a joint return.** Raymond's wages for the year are $200,000 and Debra's wages are $200,000. Neither Raymond nor Debra's employer would be required to withhold the .9% Medicare surtax since neither Debra nor Raymond's wages exceed the $250,000 threshold amount for married persons filing a joint return. However, on their joint return, their combined wages of $400,000 would exceed the $250,000 threshold by $150,000. Therefore, they would have to pay an *additional* Medicare Surtax of $1,350 ($150,000 x .9%) with their individual income tax return.

2. ***Self Employed* Individuals.** Self-employed individuals will be responsible for the entire 2.9% Medicare tax on the first $200,000 ($250,000 if married filing jointly) of self-employed earnings, plus 3.8% (up from 2.9%) on the excess. **Planning Alert!** Although self-employed individuals will, as in the past, be allowed an "above-the-line" deduction for one half of the 2.9% Medicare tax when computing their Federal income tax, no deduction is allowed for the additional .9% Medicare Surtax.

NEW 3.8% MEDICARE SURTAX ON *INVESTMENT* INCOME (Effective for tax years beginning after 2012). Since the inception of the Medicare program, the Medicare tax has only been imposed on an employee's "*wages"* and a self-employed individual's *"earned* income". **Starting in 2013**, a new 3.8% Medicare Surtax will be imposed on all or a portion of the *net investment income* (e.g., interest, dividends, annuities, royalties, rents, and capital gains) **of certain individuals. The tax will apply to married individuals filing jointly** with modified adjusted gross income (MAGI) **exceeding $250,000 (exceeding $200,000 if single, $125,000 if married filing separately).** Trusts and estates that have *net investment income* in excess of certain threshold amounts will also be required to pay the 3.8% Medicare Surtax, unless the income is timely distributed to beneficiaries. However, if the income is timely distributed, the beneficiaries of the trust or estate may be subject to the Medicare Surtax. **Planning Alert!** Self-employed taxpayers have historically received an *income tax deduction* for one-half of the Medicare tax they pay on their self-employed income. Under the new law, no *income tax deduction* is allowed for any part of this Medicare Surtax imposed on net investment income, even for self-employed individuals.

1. **Calculating The New 3.8% Medicare Surtax.** The Medicare Surtax on investment income is **3.8% of the lesser of: 1)** *net investment income,* **or 2***) modified adjusted gross income* (MAGI) in excess of the threshold amount (i.e., **$250,000** for married individuals filing joint returns, **$200,000** for single individuals, or **$125,000** for married individuals filing separately). **Example.** Let's assume for 2013 Raymond and Debra are married and file a joint return and their MAGI is $270,000 (which includes $30,000 of *net investment income*). The Medicare surtax will be imposed on the **lesser of 1)** their *net investment income* of **$30,000, or 2)** their MAGI ($270,000) less the threshold amount ($250,000) **or $20,000.** Therefore Raymond and Debra's Medicare Surtax would be $760 (3.8% of $20,000).

2. ***Net Investment Income.*** Generally, net investment income includes the following types of income (net of allocable deductions): **1)** interest, dividends, annuities, royalties, and rents. However, the foregoing income is not "investment income" if the income is derived in the ordinary course of a trade or business which is not a "passive activity"; **2)** the income from a business that trades in *financial instruments or commodities*" **unless the income is *self-employment* income** subject to the 2.9% Medicare tax on *earned* income*;* **3)** the *operating* income from any other trade or business which is a "passive activity," **unless the income is *self-employment* income** subject to the 2.9% Medicare tax on *earned* income; and **4)** gain from the disposition of property other than property held in a trade or business which is not a "passive activity". For purposes of the 3.8% Medicare Surtax, a **"passive activity"** is any business activity (other than an activity conducted through a C corporation) in which the taxpayer does not "materially participate" under the provisions of §469 dealing with the limitations on losses and credits for passive activities. **For example,** an individual is deemed to *materially participate* in a business and, therefore, the business is not passive as to that individual, if the individual spends more than 500 hours during the year working in the business. Please see Regulation 1.469-5T for the various ways, including the more than 500 hour rule, an individual can show material participation in a trade or business activity.

   Planning Alert! The above "passive activity rule" has several ramifications. First of all, it makes trade or business income passing through to an S corporation shareholder subject to the 3.8% Medicare Surtax unless the shareholder materially participates in the business of the S corporation. Secondly, the new rule subjects the trade or business income from a partnership passing through to a limited partner (other than guaranteed payments which are subject to self-employment taxes under current law) subject to the 3.8% Medicare Surtax unless the limited partner materially participates in the business of the partnership. Thirdly, it subjects rental income, from pass-through entities and from rental properties owned directly, to the 3.8% Medicare Surtax unless the taxpayer materially participates in the rental activity. **Caution!** Generally, §469 presumes that a taxpayer does not materially participate in a rental activity. However, a taxpayer may overcome this presumption and materially participate in a rental activity if: **1)** the rental activity involves the rental of real property; **2)** the taxpayer is classified as a *real estate professional* under §469(c)(7) (i.e., performs more than 750 hours of services during the year in real property trades or businesses in which the taxpayer materially participates and more than 50% of the personal services performed in trades or businesses by the taxpayer during the year are performed in real property trades or businesses in which the taxpayer materially participates); **and 3)** the taxpayer "materially participates" in the real estate rental activity under Regulation 1.469-5T (e.g., works more than 500 hours in the business). **Please see Regulation 1.469-9 for the rules for demonstrating material participation in a real estate rental activity.**

   Example. Let's assume that Raymond owns 100% of an S corporation that operates a business that does not trade in financial instruments or commodities, and the business is not a passive activity (e.g., Raymond works in the business more than 500 hours during the year). Further assume that the S corporation has the following income: dividends, interest, net capital gains from the sale of stocks, and operating business income. Generally, the dividends, interest, and net capital gains (net of allocable expenses) would be "net investment income" for purposes of the new 3.8% Medicare Surtax. As under current law, the K-1 income from the business operations of the S corporation would not be subject to the regular 2.9% Medicare tax. In addition, Raymond's K-1 income from business operations would

not be subject to the new 3.8% Medicare Surtax since Raymond materially participates in the business of the S corporation. However, let's change the facts and assume that Raymond's ownership interest in the S corporation is *passive* (e.g., Raymond does not materially participate in the business). If Raymond does not materially participate in the business of the S corporation, the K-1 income from business operations would remain exempt from the 2.9% Medicare tax on earned income. However, Raymond's income from the S corporation's business operations would constitute "net investment income" for purposes of the 3.8% Medicare Surtax, since he does not materially participate in the business.

Gains From The Sale Of Assets Held In A Trade Or Business. Generally, gains from the disposition of assets used in a trade or business are subject to the 3.8% Medicare surtax only if the business is a "passive activity" with respect to the owner or is a business of trading in financial instruments or commodities.

Certain Income Exempt From Medicare Surtax. For purposes of the 3.8% Medicare surtax on investment income, "investment income" does not include **tax-exempt bond interest; gain on the sale of a principal residence** otherwise excluded from income under the home-sale exclusion provisions of §121; or **distributions from qualified plans, IRAs, 403(b) annuities, etc. Planning Alert!** Taxable distributions from qualified plans, traditional IRAs, etc., will increase MAGI which could, in turn, push individuals over the $250,000 (joint return) or $200,000 (single return) thresholds, subjecting their net investment income to the Medicare Surtax.

3. **Applying The 3.8% Medicare Surtax To Estates And Trusts.** Under the *Health Care Act*, **starting in 2013,** a trust or estate that has *undistributed* net investment income **must pay the 3.8% Medicare Surtax on the lesser of: 1) the *adjusted gross income*** of the trust **in excess of a *threshold amount,* or 2) the undistributed net investment income** of the trust. The *threshold amount* is the dollar level where the *highest income tax rate* for trusts and estates begins. **Example.** Let's assume that in 2013 a trust has AGI of $15,000 (including undistributed net investment income of $10,000), and the top income tax bracket kicks in once the trust's taxable income exceeds $12,000. The new 3.8% Medicare Surtax will be imposed on the **lesser of: 1)** the trust's *adjusted gross income* in excess of the threshold amount ($15,000-$12,000) which is **$3,000, or 2)** the trusts undistributed net investment income of **$10,000.** Therefore, the Medicare tax would be $114 (3.8% of $3,000). **Tax Tip.** Certain types of trusts will be exempt from this Medicare Surtax such as charitable remainder trusts, grantor trusts (i.e., trusts treated under the income tax rules as owned by the grantor), and simple trusts (i.e., trusts requiring all income to be distributed to the beneficiary at least annually). **Caution!** Although these trusts are not subject to the Medicare Surtax, the net investment income generated by these trusts may ultimately be taxed to an individual subject to the 3.8% Medicare surtax.

4. **Observations And Planning Considerations.** The following are a few observations and planning considerations relating to the new 3.8% Medicare Surtax:

Tax-Exempt Income Becomes More Valuable. Beginning in 2013, tax exempt municipal bond interest will potentially provide higher income taxpayers with a double tax benefit: **1)** the interest will not be included in the taxpayer's MAGI thus reducing the chance that the taxpayer will exceed the income thresholds for the 3.8% Medicare Surtax, and **2)** the tax-exempt interest itself is exempt from the Medicare Surtax.

Additional Benefits For Contributions To Qualified Retirement Plans. Deductible contributions to qualified retirement plans (e.g., traditional IRAs, §401(k)s, SEPs, etc.), will potentially provide individuals with two additional tax benefits: **1)** the contributions will reduce MAGI and, therefore, the chance of exceeding the income thresholds for the Medicare Surtax, and **2)** retirement plan distributions received later will be exempt from the Surtax.

Roth IRA Conversions. Since tax-free distributions from a Roth IRA do not increase MAGI and thus will not increase exposure to the Medicare Surtax, this should be factored into any analysis of whether

an individual should convert an existing IRA to a Roth IRA. However, if the conversion occurs after 2012, the income triggered by the conversion increases MAGI and therefore an individual's potential exposure to the Medicare Surtax. Thus, by converting to a Roth prior to 2013, individuals may avoid any Medicare Surtax that would otherwise apply because of the conversion. **Caution!** Whether an individual should convert a traditional IRA to a Roth IRA is a complex issue requiring detailed calculations and projections. This new Medicare Surtax is just one more factor to consider.

Recognizing Gains On Investments Held More Than One Year In 2010. With the scheduled increase in the maximum long-term capital gains rates from 15% to 20% in 2011, and the imposition of the new 3.8% Medicare Surtax on capital gains starting in 2013, timing sales of stocks, bonds, or other securities has become much more important. High-income individuals may save taxes by selling their appreciated long-term capital investments that have peaked in value in 2010, instead of waiting until 2011 or later. Likewise, overall tax savings may occur if these taxpayers postpone selling investments producing a capital loss until 2011 or later, so that those losses can shelter capital gains that otherwise would be subject to the higher 20% capital gains rate and the 3.8% Medicare Surtax. **Caution! Always consider the economics of a sale or exchange first!**

DEDUCTION THRESHOLD FOR MEDICAL EXPENSES RAISED FROM 7.5% TO 10% OF AGI (Effective for tax years beginning after 2012). Currently, individuals are generally allowed an itemized deduction for unreimbursed medical expenses (including un-reimbursed health insurance premiums), but only to the extent that the expenses exceed 7.5% of adjusted gross income (10% for alternative minimum tax purposes). **Starting in 2013**, the *Health Care Act* generally increases the threshold for claiming an itemized deduction for unreimbursed medical expenses from 7.5% of adjusted gross income (AGI) to 10% of AGI. However, there is a **transition rule for individuals age 65 or older. Through 2016**, if either the taxpayer or the taxpayer's spouse is **age 65 or older** before the close of the tax year, the 7.5% threshold will continue to apply. **Planning Alert!** Since the alternative minimum tax (AMT) treatment of the itemized deduction for medical expenses is not changed, medical expenses will continue to be deductible for AMT purposes only to the extent that they exceed 10 percent of AGI, even if the taxpayer (or taxpayer's spouse) is age 65 or older before the close of the tax year.

ANNUAL CONTRIBUTIONS TO *HEALTH* FSAS CAPPED AT $2,500 (Effective for tax years beginning after 2012). Employer-sponsored cafeteria plans are one of the most popular tax-free fringe benefits offered to employees. Under these plans, employees can generally select certain tax-free benefits or taxable cash payments. Benefits provided under a cafeteria plan may be funded through employer contributions, employee salary reductions, or a combination of both. One common option under these plans is a *health care flexible spending arrangement* (Health FSA). These Health FSAs have become especially popular because they allow an employee to lower his or her income tax by paying for common medical expenses with before-tax dollars. Under current law, there is no limit (except as imposed by the plan itself) on the amount an employee can elect to contribute to a health FSA through salary reductions. **Starting in 2013**, the *Health Care Act* requires that cafeteria plans cap the annual salary reduction contribution to a health FSA at $2,500. The $2,500 cap will be adjusted for inflation after 2013.

EMPLOYER'S DEDUCTION FOR MEDICARE PART D PAYMENTS TO RETIREES REDUCED BY SUBSIDY (Effective for tax years beginning after 2012). Currently, businesses providing employees a *qualified retiree prescription drug plan*, are entitled to a special federal subsidy for a portion of the *allowable* retiree drug costs under the plan. A "qualified retiree prescription drug plan" is generally employment-based retiree health coverage that has an actuarial value at least equal to the Medicare Part D standard plan for the risk pool, and that meets certain other disclosure and record-keeping requirements. This federal subsidy is excluded from the employer's federal taxable income. However, under current law, an employer is allowed a full tax deduction for its cost of the qualified retirement prescription plan, unreduced by the tax-free subsidy from the federal government. **For tax years beginning after 2012**, the *Health Care Act* requires employers to reduce their deduction for the retiree prescription drug plan by the federal subsidy. **For example**, let's assume that an employer incurred allowable qualified retiree prescription drug plan costs of $100,000 which resulted in a federal subsidy of $28,000. Under current law,

the $28,000 subsidy would not be included in the employer's income and the full $100,000 cost would be deductible. Under the new law, beginning in 2013, the subsidy would still not be included in income, however, the employer's income tax deduction would be reduced to $72,000 ($100,000 minus $28,000).

COMPENSATION DEDUCTION FOR HEALTH INSURANCE COMPANIES LIMITED TO $500,000 (Generally effective for amounts paid in tax years beginning after 2012). Health insurance providers will not be able to deduct compensation to any single officer, director, or employee in excess of $500,000, **for amounts paid in tax years beginning after December 31, 2012. Planning Alert!** For *deferred* compensation arrangements, the limit applies to compensation **paid in tax years beginning after December 31, 2012**, that is attributable to **services performed in a tax year beginning after December 31, 2009.**

EXCISE TAX ON SALE OF MEDICAL DEVICES (Effective for sales after 2012). For sales after 2012, a tax equal to 2.3% of the sale price is imposed on the sale of any taxable medical device by the manufacturer, producer, or importer of such device. A taxable medical device is any device defined in section 201(h) of the Federal Food, Drug, and Cosmetic Act, that's intended for humans. However, the excise tax doesn't apply to eyeglasses, contact lenses, hearing aids, and any other medical device determined by IRS to be of a type that is generally purchased by the general public at retail for individual use.

SELECTED PROVISIONS FIRST EFFECTIVE IN 2014

PENALTY FOR FAILING TO CARRY HEALTH INSURANCE (Effective for tax years ending after 2013). Beginning in 2014, the *Health Care Act* provides a monthly penalty for individuals who do not have "minimum essential health coverage" for a month. The penalty will be paid with an individual's income tax return. **For 2014,** the monthly penalty is *generally* **one-twelfth of the greater of 1) $95** per uninsured adult in the household, **or 2) 1%** of household income in excess of the threshold amount of income required for filing a return (e.g., $9,350 for single individuals and $18,700 for joint filers, for 2010). The penalty increases **for 2015** to **one-twelfth of the greater of 1) $325** per uninsured adult in the household, **or 2) 2%** of household income in excess of the threshold amount of income required for filing a return. **For 2016** and future years, the penalty will *generally* be **one-twelfth of the greater of 1) $695** per uninsured adult or **2.5%** of the household income in excess of the threshold amount of income required for filing a return. The 2016 penalty amounts will be indexed for inflation for years after 2016. Certain individuals may be granted an exemption from this penalty, such as: individuals having financial hardship or religious objections; American Indians; those without coverage for less than three months; aliens not lawfully present in the U.S.; incarcerated individuals; those for whom the lowest cost plan option exceeds 8% of household income; individuals with incomes below the tax filing threshold; and individuals residing outside of the U.S. The penalty is to be included with the individual's income tax return. **Note!** Interestingly, the IRS is not permitted to file a notice of lien with respect to any property of a taxpayer by reason of any failure to pay the penalty and they are not permitted to levy on any property of a taxpayer with respect to any failure to pay the penalty.

PREMIUM ASSISTANCE TAX CREDITS FOR LOW AND MIDDLE INCOME TAXPAYERS (Effective for years ending after 2013). In order to reduce the cost of health care coverage for low and middle income taxpayers, starting in 2014, the *Health Care Act* creates a *refundable* tax credit (the "premium assistance credit") for eligible individuals and families who purchase health insurance through a "Health Insurance Exchange" (which each state must establish no later than 2014). Unlike the classic refundable credit which is paid directly to the taxpayer, the *premium assistance credit* is payable in advance directly to the insurer. To obtain the credit, an eligible individual would generally enroll in a plan offered through a state *Health Insurance Exchange*, report his or her income to the Exchange, and based on that information the IRS will pay the premium assistance credit directly to the insurance plan. The individual will be required to pay the difference between the credit amount and the total premium charged for the plan. The credit is computed on a sliding scale based on the individual's income, and is available for individuals and families with incomes of up to 400% of the federal poverty level who are not eligible for Medicaid, employer-sponsored insurance, or other acceptable coverage.

PENALTY FOR LARGER EMPLOYERS THAT FAIL TO PROVIDE ADEQUATE EMPLOYEE HEALTH COVERAGE (Effective after 2013). The *Health Care Act*, **starting in 2014**, generally imposes a penalty on certain larger employers that fail to offer full-time employees the opportunity to enroll in an employer-sponsored health plan providing "minimum essential coverage." This penalty will generally *not apply* to any employer that employed on average *less than 50* full-time employees during the preceding calendar year. However, even if an employer employs 50 or more full-time employees, the employer will still not be subject to the penalty unless at least one full-time employee is certified to the employer as having purchased health insurance through a state *Health Insurance Exchange* with respect to which a premium tax credit or cost-sharing reduction is allowed or paid to the employee. Therefore, **if an employer doesn't have any full-time employees with income low enough to qualify the employee to receive a subsidy when purchasing a health plan through the health insurance exchange, the employer will not pay the penalty.** The penalty for any month is an excise tax equal to the **number of full-time employees over a 30-employee threshold** during the applicable month (even if only one employee is receiving a premium tax credit or cost-sharing reduction) **multiplied by $166.67. Example.** For 2014, Tool Time, Inc. has 60 full-time employees and fails to offer minimum essential coverage. One of Tool Time's employees receives a tax credit for the year for enrolling in a state health insurance exchange plan. Tool Time will owe a penalty of $166.67 per month for each employee over the 30-employee threshold. Therefore, a penalty of **$5,000** [$166.67 x 30 (60 minus 30)] will apply **for each month Tool Time fails to provide minimum essential coverage.**

FREE CHOICE VOUCHERS (Effective after 2013). Congress recognized that some employers might offer a qualified employee health insurance plan that required lower-paid employees to pay more than they could afford in order to participate in the employer's plan. To address this concern, starting in 2014, the *Health Care Act* requires an employer that offers employee health insurance coverage under a qualified plan to give a tax-free voucher (called a "free-choice voucher") to employees: **1)** whose household income does not exceed 400% of poverty line income, **2)** who do not participate in the employer-sponsored health plan, and **3)** whose required employee contribution to the employer's qualified health plan would be more than 8% but not more than 9.8% of the employee's household income. The employee could then use the *free choice voucher* to purchase health insurance coverage on the *Health Insurance Exchange*. The value of the voucher would generally be the amount that the employer would have contributed to the employer-sponsored health plan on behalf of the employee had the employee signed up for the employer's plan. Employers providing free-choice vouchers will generally not be subject to penalties imposed for failure to provide adequate employee health coverage, discussed previously, for employees receiving the vouchers.

SMALL EMPLOYERS MAY OFFER "QUALIFIED HEALTH PLAN" COVERAGE THROUGH CAFETERIA PLAN (Effective for tax years beginning after 2013). For tax years beginning after 2013, "qualified employers" may offer coverage under a "qualified health plan" provided through a health insurance exchange as a qualified benefit under a cafeteria plan. A "qualified employer" is generally an employer that employees 100 or fewer employees. However, for plan years beginning before 2016, states may choose to treat only employers that employ 50 or fewer employees as a "qualified employer".

ANNUAL FEE REQUIRED OF HEALTH INSURANCE PROVIDERS (Effective for calendar years beginning after 2013). Generally, entities engaged in the business of providing health insurance with respect to U.S. health risk will face an annual flat fee, effective for calendar years beginning after 2013. The fee will be determined with respect to net premiums written after 2012, with respect to health insurance for any U.S. health risk. The aggregate annual flat fee will be: $8 billion for 2014; $11.3 billion for 2015 and 2016; $13.9 billion for 2017; and $14.3 billion for 2018. The fee will be indexed to the rate of premium growth for later years. Each covered entity's share of the aggregate annual fee is determined by the ratio of its net premiums written during the preceding calendar year with respect to health insurance for any U.S. health risk, to the aggregate net written premiums of all covered entities during such preceding year with respect to such insurance. Net premiums written during the calendar year that are not more than $25 million are not taken into account for this purpose; for a covered entity's net premiums written during the calendar year that are more than $25 million but not more than $50 million, 50% are taken into account; and 100% of net premiums written in excess of $50 million are taken into account.

SELECTED PROVISIONS FIRST EFFECTIVE IN 2018

EXCISE TAX ON HIGH COST EMPLOYER SPONSORED HEALTH COVERAGE (Effective for tax years beginning after 2017). For tax years beginning after 2017, insurers will be subject to a nondeductible excise tax if the aggregate value of employer sponsored health insurance coverage for an employee (plus any former employee, surviving spouse and any other primary insured individual) exceeds a threshold amount. The tax is equal to **40% of the aggregate value of the health insurance coverage that exceeds the threshold amount,** calculated using a complex formula. In general, **for 2018,** the **threshold dollar amount is $10,200** for **individual coverage and $27,500 for family coverage.** However, increased thresholds apply for certain classes of taxpayers. **Please see §4980I for details.**