Dwayne M Dills, CPA PC

1278 Hendersonville Road, Suite B
Asheville, NC 28803
Phone 828-398-0257 / Fax 828-274-7020
dillscpa@charter.net

INTRODUCTION

After months of debate, Congress finally passed the ***Health Care Act of 2010*** (Health Care Act) – perhaps the most far-reaching legislation in a generation. It is designed to reform fundamentally the entire U.S. health care system. Once this legislation is fully implemented, it will have a major impact on virtually every business and individual by requiring the majority of U.S. residents not covered by Medicaid or Medicare to obtain health care coverage either individually or through his or her employer. However, it will take several years for this legislation to become fully operative because the effective dates for the various provisions are phased in over several years. Some of the provisions begin as early as 2010, while others will not kick in until 2018. Although the centerpiece of this massive health care reform legislation is a requirement that the majority of U.S. residents obtain health insurance, this requirement generally doesn't become effective until 2014. However, many important *tax* changes are effective *before* 2014.

In addition, on March 18, 2010, President Obama signed the ***Hiring Incentives To Restore Employment Act of 2010*** (HIRE Act) providing employers that hire qualifying unemployed workers with temporary payroll tax relief, as well as a tax credit if the employee is retained for at least 52 weeks.

We are sending this letter to keep you abreast of important Federal tax changes contained in this recent legislation. As you read the following highlights, please keep in mind that some of these tax changes may require more immediate action than others. Consequently, pay careful attention to the **effective date** and sunset date (if applicable) of each new provision, which we **highlight prominently** in each segment.

Planning Alert! We highlight only *selected* provisions of the *Health Care Act*, and we focus primarily on the *tax provisions.* If you have heard or read about any provision not discussed in this letter, feel free to call our office. We will help you determine how the provision impacts you or your business. This letter also contains planning ideas. However, you cannot properly evaluate a particular planning strategy without calculating your overall tax liability (including the alternative minimum tax) with and without the strategy. You should also consider any state income tax consequences of a particular planning strategy. We recommend you call our firm before implementing any tax planning technique discussed in this letter, or if you need more information.

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HIGHLIGHTS OF THE HEALTH CARE AND HIRE ACTS

Overview

The centerpiece of the *Health Care Act* is a requirement that almost all Americans obtain a minimum level of health care coverage, or pay a penalty. It is anticipated that businesses will play a key role in this mandate because larger employers must provide employees with qualifying health coverage, or pay an additional tax. Qualifying smaller businesses will be exempt from this so-called *play-or-pay* tax. Individuals not covered by a qualifying employer health care plan and who do not maintain minimum health insurance coverage will be subject to a penalty tax. Lower and middle income individuals will get either a refundable tax credit or employer-paid voucher to help pay for their health insurance. **No later than 2014**, each state will be required to establish an American Health Benefit Exchange ("Health Insurance Exchange") to help individuals and qualifying small employers in that state acquire qualified health care coverage.

To help fund this new health care mandate, the *Health Care Act* imposes over $400 billion in new taxes and fees on employers and individuals. Perhaps the most controversial are the two new taxes on higher-income taxpayers: an additional Medicare Surtax on *earned* income, and a separate Medicare Surtax on *investment* income. As expected, it will be up to the IRS to oversee a significant part of health care reform in terms of administering and enforcing the additional taxes on individuals and employers, determining whether the various exemptions from those taxes have been satisfied, and enforcing a new regimen of information reporting requirements.

From a planning standpoint, one of the most important aspects of this new legislation is that Congress has adopted various effective dates for the new provisions, spanning an eight-year period. Although most of the health coverage mandates **are not required until 2014**, several of the most important tax changes are effective ***before* 2014.** Individuals and businesses have several years to prepare for the insurance coverage mandates. However, the *tax* changes will require more immediate attention. Consequently, this letter is mostly devoted to coverage of the new *tax provisions* contained in this new legislation and to *tax planning* that might be advisable in the relatively near future. So that you can more easily identify which provisions require immediate attention, and which provisions will be effective down the road, we begin with *a general overview of the effective dates* of the more important changes, *followed by a more detailed discussion*:

- **Starting in 2010,** the *Health Care Act* provides for a new tax credit for qualifying small businesses that provide employee health insurance; increases the adoption tax credit and makes it refundable; and imposes a new 10% excise tax on indoor tanning services (effective July 1, 2010). In addition, the *Hiring Incentives To Restore Employment Act of 2010* temporarily provides a partial exemption from payroll taxes; creates a temporary tax credit for businesses that hire and retain certain unemployed workers; and extends for one year (for tax years beginning in 2010) the $250,000 §179 deduction for purchases of qualified business property.

- **Starting in 2011,** the *Health Care Act* imposes a new restriction on tax-free reimbursements of nonprescription drugs, and increases the penalty for non-qualifying distributions from health savings accounts (HSAs) from 10% to 20%. **Planning Alert!** Unless Congress changes existing laws, 2011 will also usher in an automatic increase in the top individual income tax rate from 35% to 39.6%, and an increase in the top long-term capital gains rate from 15% to 20%.

- **Starting in 2012,** the *Health Care Act* requires businesses that pay $600 or more to a *corporation* to file a Form 1099. In addition, businesses that pay $600 or more for the purchase of property must file a Form 1099.

- **Starting in 2013**, the *Health Care Act* imposes a new .9% Medicare Surtax on the *earned income* and a 3.8% Medicare Surtax on the *unearned income* of higher-income taxpayers; increases the medical expense deduction threshold from 7.5% to 10% of AGI; caps employee contributions to health care flexible savings accounts at $2,500; eliminates the deduction for the subsidized portion of employers' Medicare Part D payments to retirees; and places a $500,000 deduction cap on compensation paid by certain health insurance companies.

- **Starting in 2014**, the *Health Care Act* begins implementing its health care coverage mandate with several new provisions, including: penalties for individuals who remain uninsured; tax incentives for low-income individuals to buy health insurance; penalties for larger employers that fail to provide adequate coverage for employees; a voucher system that will help certain lower-income employees obtain health insurance coverage; a host of new fees and taxes on various businesses within the health care industry; and a requirement that each state have a

Health Insurance Exchange up and running.

- **Starting In 2018,** a 40% excise tax will be imposed on so-called *Cadillac health plans.*

SELECTED **PROVISIONS FIRST EFFECTIVE IN 2010**

HIRE Act Offers Employers Tax Incentives To Hire The Unemployed. On March 18, 2010, President Obama signed the *Hiring Incentives To Restore Employment Act of 2010* (HIRE Act) providing employers that hire qualified unemployed workers with temporary payroll tax relief, as well as a tax credit if the employee is retained for at least 52 weeks. Any employer **that *hires* a *qualified unemployed worker* after February 3, 2010 and before January 1, 2011,** will get an exemption from the employer's 6.2% share of the worker's Social Security taxes on *wages paid* to the employee from **March 19, 2010 through December 31, 2010.** In addition, for each qualifying worker retained for at least 52 **consecutive** weeks, the employer will get an *additional* tax credit, *up to $1,000 per worker*, when they file their 2011 income tax returns. This temporary Social Security tax exemption will have no effect on the employee's future Social Security benefits, and employers would still need to withhold the *employee's* 6.2% share of Social Security taxes, as well as income taxes. The employer will also still be required to withhold and/or pay the employer and employee's shares of the Medicare tax. To help you determine if your business may qualify for either of these new tax incentives, the following are answers to questions that are commonly being asked:

- **How Do I Determine If My New Hire Is A "*Qualified Unemployed Worker?*"** Any new hire who began employment **after February 3, 2010** and **before January 1, 2011** will qualify if he or she: **1)** has been employed for no more than 40 hours during the 60-day period immediately preceding the date the employment begins, **2)** is not "related to the employer" (discussed in more detail below), **3)** signs an affidavit (using Form W-11 discussed in the *Planning Alert* below) under penalties of perjury that he or she has not been employed more than 40 hours during the 60-day period ending on the employment starting date, and **4)** was not hired to replace an existing worker who was terminated (*unless* the previous worker terminated voluntarily or was terminated for cause). **Tax Tip.** The IRS says that the new worker can still qualify even if he or she was hired to replace a worker who was previously laid off because of lack of work, or if the same worker is re-hired after being earlier laid off due to lack of work (assuming that the re-hired worker was employed no more than 40 hours during the 60-day period preceding the re-hire date). The IRS also confirms that the new employee could be a recent college or high school graduate who meets the 40-hour/60-day requirement because he or she was previously a full-time or part-time student.

  - **Planning Alert!** The IRS has issued new **Form W-11** ("*Hiring Incentives to Restore Employment (HIRE) Act Employee Affidavit*") that may be used as the affidavit signed by the new employee certifying that he or she satisfies the 40-hour/60-day requirement discussed above. You can download a copy of this form from the IRS website at www.irs.gov. The IRS says that this form must be executed by the employee in order for the employer to claim the payroll tax exemption and the new hire retention credit. However, the employer is not required to file Form W-11 with the IRS, it only needs to be retained in the employer's files. Also, the IRS has recently released *revised* Forms W-2 and W-3 along with instructions on how employers are to report wages that qualify for the payroll tax relief.

- **Which Workers Are Disqualified Because They Are "Related To The Employer?**" Generally, an employee is "related to a qualified employer" and therefore will not qualify for the payroll tax exemption or the $1,000 tax credit if the employee is the business owner's son, daughter, or descendant of either; stepson or stepdaughter; brother, sister, stepbrother, or stepsister; father, mother, or ancestor of either; stepfather or stepmother; nephew or niece; uncle or aunt; son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law. These rules can get fairly complicated especially when you have family-owned corporations, partnerships, LLCs, etc. **Please call** our firm if you need additional information.

- **How Large Can The Tax Savings Be For The Employer?** Because the Social Security tax only applies to the first $106,800 of wages paid in 2010, the maximum payroll tax forgiven for any one qualifying employee is $6,621.60 ($106,800 x 6.2%). **Planning Alert!** In order to determine the true savings produced by the payroll tax exemption, we must factor in the employer's income tax rate since the payroll taxes would otherwise be deductible if paid. **For example,** for a corporation with an effective income tax rate (Federal and State) of 40%, the maximum after-tax savings for any one employee would be $3,972.96 ($6,621.60 X 60%) since the employer's portion of the Social Security tax would otherwise be deductible for income tax purposes.

- **Which Employers Qualify For The Exemption?** Taxable businesses, tax-exempt businesses, and public colleges and universities qualify for the exemption. **Planning Alert!** Federal, state, and local government employers (other than public colleges and universities) and household employers ***do not*** qualify.
- **How Does A Business Claim The Payroll Exemption?** The payroll tax exemption is generally claimed on Form 941 ("Employer's QUARTERLY Federal Tax Return") beginning with the **second quarter of 2010.** For wages paid to qualified employees during the **period March 19 through March 31, 2010** (the first quarter of 2010), the exemption will be claimed on the employer's Form 941 for the second quarter of 2010. **Planning Alert!** The IRS is currently revising Form 941 for use beginning with the second calendar quarter of 2010, and plans to release the revised form in May, 2010, along with the form's new instructions.

- **What If The Qualified Unemployed Worker Also Qualifies The Employer For The "Work Opportunity Tax Credit?"** It is entirely possible that hiring a *qualified unemployed worker* could also qualify the employer for the *Work Opportunity Tax Credit* (WOTC) that is allowed under current law. The WOTC is a nonrefundable credit allowed to employers that hire employees from qualified targeted groups (e.g., certain low income individuals, disabled veterans, unemployed veterans, summer youth, unemployable youth, ex felons). For more detailed information regarding the types of workers that will qualify an employer for the WOTC, please consult the instructions to the latest IRS **Form 8850** ("Pre-Screening Notice and Certification Request For the Work Opportunity Credit"), which can be obtained from the IRS website at www.IRS.gov. **Planning Alert!** Generally, wages paid to a qualifying employee cannot also be used to qualify the employer for the WOTC. However, an employer that wishes to claim the WOTC with respect to that qualified employee can elect out of the payroll tax exemption with respect to wages paid to that qualified employee. **Tax Tip!** If the tax benefit of the WOTC is greater than the tax benefit of the payroll tax exemption, the employer should elect out of the exemption and choose the WOTC instead. For example, if an employer paid $20,000 of wages to a newly-hired employee who qualified for a maximum $2,400 WOTC and also qualified for the payroll tax exemption, the employer would get a larger benefit by taking the WOTC of $2,400 rather than the payroll tax reduction of $1,240 ($20,000 x 6.2%).

- **How Does An Employer Qualify For The Credit (Up To $1,000) For Retaining A Worker?** An employer qualifies for the credit if the employer hires a *qualified unemployed worker* (i.e., a worker whose wages qualify for the exemption from FICA taxes described above) who: **1)** continues to be employed by the employer for at least 52 consecutive weeks, and **2)** receives wages during the last 26 weeks of that 52-week period that are at least 80% of the wages he or she received during the first 26 weeks. The amount of the **credit is the lesser of $1,000 or 6.2% of wages** (as defined for income tax withholding purposes) paid by the employer to the qualified retained employee during the 52-consecutive-week period. **Note!** The credit will be $1,000 where the retained worker's wages during the 52-consecutive-week-period exceed $16,129.03. **Planning Alert!** To qualify an employer for the credit, the new worker must have begun work after **February 3, 2010 and before 2011.** Thus, due to the 52-consecutive-week requirement, the credit will generally not be available for employers until 2011. **Tax Tip.** It appears that if an employer elects to forgo the payroll tax exemption for an otherwise qualifying employee and takes the Work Opportunity Tax Credit (WOTC) instead, the employer may also take the $1,000 credit for qualified retained workers if the employee otherwise qualifies.

Small Employers Get New Credit For Providing Employee Health Insurance. One of the pleasant surprises coming from the *Health Care Act* is a new and immediate tax credit for ***"eligible small employers"*** that **1)** offer health insurance to employees, and **2)** pay at least 50% of the cost of insurance. For **tax years beginning after 2009 and before 2014**, *the Health Care Act* allows an *eligible small employer* to take a credit of up to 35% of the cost of qualifying employee health insurance purchased from state-licensed health insurance companies. **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 implemented a significant initiative to help small businesses get the guidance and information they need to determine if they qualify. For example, the IRS has sent out 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. To help you navigate the rules for this new credit, the following are answers to common questions being asked:

- **How Can I Determine If My Business Is An *Eligible Small Employer* That May 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 it has **25 or more *full-time equivalent employees* (FTEs)** during the year, or if its **FTEs have *average annual wages* of**

$50,000 or more. To determine the *number of FTEs*, the new law generally requires an employer to divide 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). **To determine the *average annual FTE wages,*** an employer generally divides the employer's aggregate wages for the year by the number of FTEs. For purposes of each formula, there is a host of 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 (and members of the owners' families, *discussed in more detail below*), and to *seasonal workers* (a worker who worked no more than 120 days during the tax year). **Planning Alert!** There are special rules for aggregating employees who work within a controlled group of employers (e.g., multiple businesses with common ownership).

For example, let's assume that in 2010 you own 100% of an S corporation that: 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 you and your family members, your 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. Your *average annual FTE wages* would be $24,000 computed as follows: total annual payroll of $192,000 (excluding you and your family members) divided by 8 FTEs = $24,000. **Conclusion.** Your S corporation would be an *Eligible Small Employer* (ESE) because it has no more than 25 FTEs (it actually has 8) and the average FTE annual wages do not exceed $50,000 (average FTE wages actually are $24,000). **Tax Tip.** The IRS website (www.irs.gov) has a link to "Health Care Tax Credit" which provides a guide entitled "3 Simple Steps," that helps you determine if your business may qualify for this credit.

- **How Large Can The Credit Be?** To qualify for the credit, an *eligible small employer (ESE)* must first contribute a uniform percentage of *at least 50% of* the premium cost for each employee who enrolls in the ESE's employee health plan. For **tax years beginning in 2010 through 2013**, the *credit rate* can be as high as 35% (50% for tax years beginning in 2014 and 2015) as long as the employer has no more than 10 FTEs and the average FTE wages do not exceed $25,000. The 35% credit percentage is reduced pro rata as the number of FTEs exceed 10 and phases out completely at 25, or as FTE wages exceed $25,000 and phases out completely at $50,000. Thus, the **full amount of the credit** is available only to an employer **with 10 or fewer *FTEs*** *and* 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.** For instance, in the previous example, the S corporation would be entitled to the full 35% credit for 2010 because its 8 FTEs do not exceed 10, and its average FTE wages of $24,000 do not exceed $25,000. So, if the S corporation in this example had paid qualifying health insurance premiums in 2010 of $60,000 for its qualifying employees, it 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 late March of 2010, the IRS says that you can take the credit on employer-paid premiums made as early as the first day of your tax year beginning in 2010 (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. **Planning Alert!** 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 the 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).

- **Will The Credit Reduce The Employer's Business Deduction For Health Insurance?** Yes. For example, if an employer's effective marginal income tax rate (state and federal) is 40% and the employer also qualifies for the full 35% health insurance credit, the net tax benefit will generally be only 21% (i.e., 35% x 60%) of the qualifying insurance premiums.

- **Is The Credit Allowed For Employees Who Are Also Owners Or Family Members Of Owners?** Generally–No. 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, and certain family members of these owners. Also, wages paid to these employees are excluded for purposes of determining the number of FTEs and the amount of average annual wages.

- **Can I Get The Credit For Insurance That I Purchase For My Domestic Employee?** No. The employee must work in the employer's business operations to qualify for the credit.

- **Can A Tax-Exempt Organization Benefit From This Credit?** If the tax-exempt organization otherwise qualifies for the credit, it can get a *refundable* credit not to exceed the total amount of the **1)** employees' withheld income taxes, **2)** employees' withheld Medicare taxes (employees' share), and **3)** employer's share of the Medicare taxes paid on the employees' wages. **Planning Alert!** The credit rate for qualifying tax-exempt employers **is 25%** (instead of 35%) for **2010 through 2013** (for 2014 and 2015, the credit rate for tax exempts will be 35% instead of 50%). **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.

- **Will The Credit Offset AMT And Can The Unused Credit Be Carried Back Or Forward?** The credit will offset the alternative minimum tax (AMT). Any unused credit can generally be carried back one year and carried forward 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. For 2009, an individual was generally entitled to an adoption tax credit for qualifying adoption expenses of up to $12,150 per *eligible child*, provided that the taxpayer's modified adjusted gross income (MAGI) did not exceed certain income phase-out thresholds. **For tax years beginning after December 31, 2009 and before January 1, 2012**, the *Health Care Act* makes two significant changes: **1)** the maximum adoption tax credit is **increased to $13,170** (an inflation adjustment will apply for 2011), and **2)** the credit becomes *"refundable"* (this generally means that, to the extent the credit exceeds the taxes that you would otherwise owe without the credit, the IRS will actually send you a check for the excess). The credit also applies against alternative minimum tax (AMT). **For 2010**, the adoption credit is phased-out as your modified adjusted gross income increases from **$182,520 to $222,520** (whether you're married filing a joint return, or single). **Planning Alert!** You are generally not allowed to take the credit if you are married but do not file a joint return (i.e., you file as *married filing separately*). **Tax Tip!** Now that the adoption tax credit is *refundable* (for 2010 and 2011), taxpayers are taking a renewed interest as to how this credit works. The following are answers to questions that are frequently asked about the adoption credit:

- **Who Is An *Eligible Child*?** To qualify for the credit, the adopted child must generally be under the age of 18 *at the time the qualified adoption expense is paid*. A child who turns 18 during the year is eligible for the part of the year he or she is under age 18. A person who is physically or mentally incapable of caring for himself is also eligible, regardless of age.

- **Which Adoption Expenses Qualify For The Credit?** Qualified adoption expenses generally include adoption fees, court costs, attorney fees, and other reasonable and necessary adoption expenses (including amounts spent for meals and lodging while away from home) directly related to the adoption of an eligible child. **Planning Alert!** Expenses incurred in carrying out a surrogate parenting arrangement or in adopting a spouse's child do not qualify for the credit, nor do expenses paid using funds received from a federal, state, or local program.

- **Are There Unique Rules For A *Special Needs* Child?** Yes. If you adopt a *qualified* special needs child, you may be entitled to the full refundable credit of $13,170 even if your actual out-of-pocket adoption expenses are less. A qualified special needs child is a child who the state has determined **1)** cannot or should not be returned to his parents, *and* **2)** can't reasonably be placed with adoptive parents without assistance because of a specific factor or condition (e.g., ethnic background, age, membership in a minority group, medical condition, or handicap). You are allowed a credit in excess of actual expenses for special needs children only in the tax year the adoption becomes final. **Tax Tip.** If you finalize the adoption of a "special needs child" **by December 31, 2010**, you may receive the full *refundable* adoption tax credit of $13,170 on your 2010 return even if this is more than your out-of-pocket adoption expenses. **Planning Alert!** Only a child who is a citizen or resident of the U.S. can qualify for this special needs child tax break.

- **What If My Adoption Expenses Are Paid By My Employer?** Adoptive parents may be able to *exclude* from their gross income up to $13,170 (for 2010) of qualified adoption expenses paid by an employer under an adoption assistance program. The exclusion begins phasing out once the parents' MAGI exceeds $182,520, as discussed above. Adoptive parents may claim both a credit and an exclusion for expenses of adopting a child. They may not, however, claim both a credit and an exclusion *for the same expense*.

- **Are There Special Rules If I Adopt A Foreign Child?** Generally, you can take the adoption credit even if the adoption never becomes final. However, you are *not allowed* a credit for the adoption of a child that isn't a U.S.

citizen or resident unless and until the adoption is *finalized*.

New 10% Excise Tax On Indoor Tanning Services. 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.

Tax-Free Medical Benefits Extended To Certain Children Who Are Not Dependents. The *Health Care Act*, **effective March 30, 2010**, allows tax-free reimbursements from an employer-provided health 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. **Tax Tip.** If you are self-employed, you may now take an *above-the-line* deduction for the health insurance premiums that apply to your child who has not attained age 27 as of the end of the tax year. In addition, the 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, **effective for plan years beginning after September 22, 2010.**

***SELECTED* PROVISIONS FIRST EFFECTIVE IN 2011**

Tax Rates Begin Rising In 2011. Unless Congress changes current law, individuals are facing an increase in their federal income tax rates beginning next year. **In 2011**, the top individual income tax rate on income, other than long-term capital gains, is scheduled to jump from 35% to 39.6%. The maximum tax rate on long-term capital gains is scheduled to increase from 15% to 20%. And, the top tax rate on dividends is scheduled to increase from 15% to 39.6%. However, President Obama has proposed keeping the *qualified dividend tax* rates the same as long-term capital gains rates. **Caution!** Starting **in 2011**, current law also provides for a return of the provisions phasing out *itemized deductions* and *personal exemptions* for higher-income taxpayers (these phase-outs do not apply for 2010). Consequently, **starting in 2011**, for taxpayers who are affected by these phase-out limits, the *effective* income rates will be even higher than the *actual* statutory rates described above. Furthermore, starting in 2013, higher-income taxpayers will be subject to a new Medicare Surtax on their earned income and their investment income (discussed in more detail below). **Planning Alert!** Because income tax rates are scheduled, under current tax law, to increase substantially in 2011, tax planning is critical for 2010. You may save taxes by accelerating income into 2010. However, you should accelerate income into 2010 only after "running the numbers." We will gladly help you with this decision.

Tax-Free Reimbursements Of *Over-The-Counter* Drugs. 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 Alert!** If you have been using a tax-favored reimbursement arrangement to pay for your over-the-counter medications (e.g., to treat a chronic medical problem such as allergies), these reimbursements will become taxable **starting in 2011**, unless the drug is prescribed by a physician.

Penalty For Non-Qualifying HSA Or MSA Distributions Increased To 20%. 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 segment, **effective for distributions from an HSA or MSA after 2010**, *qualified* medical expenses include the cost of any medicine or drug *only if* it is prescribed by a physician or is insulin. Thus, 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 not only be taxable, but 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 (eligible for medicare coverage) on the date of the distribution.

Employers Will Be Required To Include Value Of Health Insurance On W-2s. 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 an employee on the employee's Form W-2. **Planning Alert!** This is only an information reporting requirement and will generally not change the tax-free treatment of employer-provided health coverage that exists under current law.

New *Simple* Cafeteria Plan For Small Employers. 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. To address this common situation, **for plan years beginning after 2010,** 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. **Tax Tip.** This change is intended to create additional incentives for small employers to offer cafeteria plan benefits to employees.

***SELECTED* PROVISIONS FIRST EFFECTIVE IN 2012**

Form 1099 Required For Payments Over $600 To *Corporations.* 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, generally by filing a Form 1099. Under current law, this reporting requirement, subject to certain exceptions, *does not apply to payments to a corporation*. Under the *Health Care Act*, **effective for payments made after 2011**, this new Form 1099 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.

Form 1099 Required For Payments Over $600 For The Purchase Of Property. Effective **for payments after 2011**, the *Health Care Act* requires a person engaged in a trade or business to file a Form 1099 for payments made for the purchase of property, if the gross payments exceed $600. **Example.** Let's assume that your business manufactures tools and, in 2012, your business purchases a truck for $25,000 from Albert. Further assume that Albert's basis in the truck was $30,000. Your business will be required to file Form 1099 with the IRS reporting the $25,000 payment, and must also provide a copy of the Form 1099 to Albert. **Planning Alert!** The $25,000 payment must be reported on Form 1099 even though Albert has a loss on the sale of the truck.

***SELECTED* PROVISIONS FIRST EFFECTIVE IN 2013**

Additional .9% Medicare Surtax On *Earned Income* Of Higher-Income Taxpayers. Payroll taxes imposed on your W-2 earnings include both a Social Security tax and a separate Medicare tax. 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). If you are self- employed, you must pay the entire 2.9% Medicare tax on your earned income. However, as a self-employed taxpayer, you are allowed to deduct one-half (1.45%) of your Medicare tax as an "above-the-line" deduction. Although the *Health Care Act* does not increase your Social Security taxes, it does increase the Medicare taxes for higher income taxpayers. **Generally, effective 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 your *W-2 wages* and your *self-employed earnings* **exceeds $250,000** if you are **married filing a joint return (exceeds $200,000 if you are single, $125,000 if you are married 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 some of the**

questions frequently asked about this new Medicare Surtax:

- **How Will This Tax Impact An *Employee*?** If you are receiving W-2 wages as an employee, this .9% increase in Medicare tax will technically be imposed on you, not your employer. However, your employer will generally be required to withhold this additional tax from your wages. Therefore, the Medicare tax rate on your 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 you are single and in 2013 you are paid $300,000 in salary. You would pay Medicare tax of $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). Thus, the new law will increase your Medicare tax by $900 ($100,000 x .9%). In addition, your employer would pay the normal employer's share of Medicare tax of 1.45% of your entire wages of $300,000, or $4,350.

- **How Will This Impact A *Self Employed* Person?** If you are a self-employed taxpayer, you will be responsible for the entire 2.9% Medicare tax on the first $200,000 ($250,000 if married filing jointly) of your self-employed earnings, plus 3.8% (up from 2.9%) on the excess. **For example**, let's again assume that you are single and in 2013 you have self-employed earnings of $300,000. You would pay Medicare tax of $5,800 (2.9% on the first $200,000 of earnings) plus an additional $3,800 (3.8% on the earnings of $100,000 exceeding $200,000). **Planning Alert!** Although you will, as in the past, be allowed an "above-the-line" deduction for one half of the 2.9% Medicare tax when computing your income tax, no deduction is allowed for the additional .9% Medicare Surtax.

- **How Does This New Medicare Surtax Apply To Married Taxpayers?** Unfortunately, this new tax can work to the disadvantage of married couples. For example, if two unmarried taxpayers each has wages of $200,000, neither would be subject to the additional .9% Medicare Surtax. However, if the two individuals are married filing a joint return, their combined wages of $400,000 would exceed the $250,000 threshold by $150,000. Thus, they would have to pay an *additional* Medicare Surtax of $1,350 ($150,000 x .9%). **Planning Alert!** If married individuals file separate returns, the income threshold for this .9% surtax is $125,000 (½ of the joint return threshold of $250,000) on each return.

- **Does This Additional Medicare Tax Impact Choice Of Business Entity?** In some instances–Yes. Under current law, operating your business as an *S corporation* may result in reducing your payroll (or self-employment) taxes. If you are the owner of an S corporation that operates a business, and you pay yourself a reasonable salary, profit that is reported to you as the owner on Schedule K-1 ("Shareholder's Share of Income, Deductions, Credits, etc.") is subject to income tax, but it is generally not subject to the self-employment tax (including the new .9% Medicare Surtax). On the other hand, if you operate your business as an entity taxed under the partnership rules (e.g., a partnership or LLC that has not elected S corporation status), the profit that is reported on your Schedule K-1 is generally subject to both income tax and to the self-employment tax. **Planning Alert!** Determining "reasonable salaries" for S corporation stockholders/employees is a hot audit issue and the IRS has taken many taxpayers to court and won! The IRS has been particularly successful where S corporation owners pay themselves no salary even though they provided significant services to the corporation. In these cases, the courts generally held that all amounts paid out to the S corporation owners were actually wages subject to FICA and Medicare taxation. Also, minimizing your self-employment tax could reduce your Social Security benefits when you retire. Furthermore, if your S corporation has a qualified retirement plan, reducing your salary may reduce the amount of contributions that can be made to the plan on your behalf since contributions to the plan are based upon your "wages." **Caution!** If you are a "passive" owner of your S corporation (i.e., you do not materially participate in the operations), **starting in 2013,** your pass-through business income (i.e., your K-1 income) may be subject to the new 3.8% Medicare Surtax on *investment* income, discussed in the next segment.

New 3.8% Medicare Surtax On *Investment* Income. 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 higher-income 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 been entitled to an *income tax deduction* for one-half of the Medicare tax they pay on their self-employed

income. Under the new law, you will not be entitled to an *income tax deduction* for any part of this Medicare Surtax imposed on net investment income, even if you are self-employed.

- **How Do I Compute The New 3.8% Medicare Surtax?** If you are married filing jointly, you will be subject to the new 3.8% Medicare tax on your *net investment income only if and to the extent* your *modified adjusted gross income* (MAGI) exceeds $250,000 ($200,000 if you are single and $125,000 if you are married filing separately). **Example.** Let's assume that in 2013 you are married filing a joint return and your MAGI is $270,000 (which includes $30,000 of *net investment income*). Your new Medicare surtax will be imposed on your *net investment income*, not to exceed your MAGI ($270,000) in excess of $250,000. Since your MAGI exceeds $250,000 by $20,000, your Medicare Surtax would be $760 (3.8% of $20,000). **Planning Alert!** If your MAGI (*excluding* your net investment income) exceeded $250,000, your entire net investment income of $30,000 would be subject to the 3.8% Medicare Surtax.

- **What Is Included In *Net Investment Income*?** Generally, net investment income includes (net of allocable deductions) interest, dividends, annuities, royalties, rents, gain from the sale of property (e.g., capital gains), and operating income from a business that trades in *financial instruments or commodities*. It also includes *operating* income from any other business which is a "passive activity" (unless the operating income constitutes *self-employment* income subject to Medicare tax on *earned* income). For this purpose, a "passive activity" is any business activity (other than an activity conducted through a C corporation) which is subject to the passive loss limitation rules because the owner does not *materially participate* in the business. For example, you are deemed to *materially participate* in a business and, therefore, the business is not passive if you spend more than 500 hours during the year working in the business. **Example.** Let's assume that you are an owner in 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., you work in the business over 500 hours per year). Further assume that the S corporation has the following income: dividends, interest, net capital gains and operating business income. Generally, the dividends, interest, and net capital gains (net of allocable expenses) would be "net investment income" subject to the new 3.8% Medicare Surtax. However, the income from business operations would not be subject to the regular Medicare tax or the new Medicare Surtax because, generally, pass-through operating income *from an S corporation* is neither classified as *self-employed* income nor *investment* income. However, if we change the facts and assume that your ownership interest in the S corporation is *passive* (e.g., you do not materially participate in the business), although the operating business income would still not be *self-employed income*, it would now constitute "net investment income" and would be subject to the 3.8% Medicare Surtax.

- **Are Gains From The Sale Of Assets Held In A Trade Or Business Subject To The Medicare Surtax?** 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 taxpayer or is a business of trading in financial instruments or commodities.

- **Is Any Investment Income Exempt From The Surtax?** Yes. 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; or distributions from qualified plans, IRAs, 403(b) annuities, etc. **Planning Alert!** Taxable distributions from qualified plans, traditional IRAs, etc., will increase your MAGI which could, in turn, push you over the $250,000 (joint return) or $200,000 (single return) thresholds, subjecting your net investment income to the 3.8% Medicare Surtax.

- **If My Income Exceeds The Threshold Amounts, Could I Be Subject To *Both* The 3.8% Medicare Surtax On My *Investment* Income And The .9% Additional Medicare Tax On My *Earned* Income?** Yes.

- **Will Gain On The Sale Of My Interest In A Pass-Through Entity Be *Net Investment Income*?** Possibly. There are technical rules for determining to what extent the gain on the sale of an interest in a partnership, LLC, or S corporation will be treated as net investment income based on the investment assets owned by the pass-through entity. These rules are quite complicated. Please call our firm if you need additional details.

- **How Does The 3.8% Medicare Surtax Impact Estate Or Trust Net Investment Income?** Estates and trusts are generally required to file income tax returns and pay income tax on taxable income that is not timely distributed to the beneficiaries. **Starting in 2013,** a trust or estate that has *undistributed* net investment income will be subject to the 3.8% Medicare Surtax only if it has *adjusted gross income* in excess of a *threshold amount*. 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 you have a trust that 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 Medicare Surtax will be imposed on **the lesser of 1)** the trust's *net investment income* ($10,000), **or 2)** the trust's AGI ($15,000) in excess of $12,000. Since the trust's AGI exceeds $12,000 by $3,000, the Medicare tax would be $114 (3.8% of $3,000). **Planning Alert!** If the trust's AGI (*excluding* the net investment income) exceeded $12,000, the entire net investment income of $10,000 would be subject to the 3.8% Medicare tax. **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 the Medicare Surtax, the net investment income generated by these trusts may ultimately be taxed to an individual who would be subject to these Medicare Surtax rules. These rules can be quite complex. Please call our firm if you need additional information.

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

- **Consider Roth IRA Conversions.** Since tax-free distributions from a Roth IRA do not increase your MAGI and thus will not increase your exposure to the Medicare Surtax, this should be factored into any analysis of whether you should convert your existing IRA to a Roth IRA. However, if the conversion occurs after 2012, the income triggered by the conversion increases your MAGI and therefore your potential exposure to the Medicare Surtax. Thus, by converting to a Roth prior to 2013, you may avoid any Medicare Surtax that would otherwise apply because of the conversion. **Caution!** Whether you should convert your traditional IRA to a Roth IRA can be an exceedingly complicated issue, and this new Medicare Surtax makes the decision even more complex. Please call our firm if you need help in deciding whether or not to convert to a Roth IRA.

- **Tax-Exempt Income Becomes More Valuable.** Investing in products that produce tax-exempt income will gain more importance. For example, 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.** By maximizing your deductible contributions to qualified retirement plans (e.g., traditional IRAs, §401(k)s, SEPs, etc.), you will potentially receive a double tax benefit: **1)** your contributions will reduce your MAGI and reduce your chance of exceeding the income thresholds that would expose your current net investment income to the Medicare Surtax, and **2)** the retirement plan distributions that you receive when you retire will be exempt from the Surtax.

- **Spreading *Investment Income* Among Family Members Through A Family Limited Partnership.** High-income taxpayers using family limited partnerships (FLP), may get an added benefit of minimizing their exposure to the 3.8% Medicare Surtax. To the extent the FLP generates *net investment income* that passes through to a family member who is below the income thresholds, the Medicare Surtax may be avoided.

- **S Corporation Owners Should Consider Taking Steps To Avoid *Passive* Activity Classification.** The income of an S corporation taxed to a high-income owner who does not materially participate in the business could be subject to the 3.8% Medicare Surtax. To avoid the surtax, the owner should consider taking the steps necessary to materially participate in the activity (e.g., working in the entity for more than 500 hours during the year). **Planning Alert!** If the S corporation owner has other passive activities with losses, the owner may prefer to remain "passive" so that the income from the S corporation may be used to offset the passive losses of the other activities.

- **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 your sales of stocks, bonds, or other securities has become much more complicated. High-income taxpayers 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. Under current law, 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. **Exception For Seniors. Through 2016**, if either the taxpayer or the taxpayer's spouse is **age 65 or older** before the close of the tax year, the increased 10% of AGI threshold will not apply and the 7.5% threshold will continue. **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 the taxpayer's spouse) is age 65 or older before the close of the tax year.

Annual Contributions To *Health* FSAs Will Be Capped At $2,500. 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 which an employee can elect to contribute to a health FSA through salary reductions. **Starting in 2013**, cafeteria plans will be required to 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. If your business provides a *qualified retiree prescription drug plan*, it is entitled to a special federal subsidy of a percentage 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 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* will require employers to reduce their business deduction for the retiree prescription drug plan by the federal subsidy. Thus, the federal subsidy will still be tax free, but the employer's tax deduction for the plan's cost will be reduced by the 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 be tax free and the full $100,000 cost would be tax deductible. Under the new law, **beginning in 2013**, the $28,000 subsidy would still be tax free, but 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, health insurance providers will not be able to deduct *current* annual compensation paid to any single officer, director, or employee in excess of $500,000, **paid in tax years beginning after December 31, 2012. Planning Alert!** For *deferred* compensation arrangements, the limit applies to compensation for **tax years beginning after December 31, 2012**, that is attributable to services performed in a **tax year beginning after December 31, 2009.**

***SELECTED* PROVISIONS FIRST EFFECTIVE IN 2014**

Penalty For Failing To Carry Health Insurance. Beginning in 2014, the *Health Care Act* provides a penalty for individuals who do not have "minimum essential health coverage." The penalty will be paid with an individual's income tax return. **For 2014,** the maximum annual penalty is *generally* **the greater of $95** per uninsured adult in the household, or **1%** of household income in excess of a threshold amount. The penalty increases for 2015, and is fully phased in starting in **2016** when the maximum annual penalty will *generally* be the greater of **$695** per uninsured adult or **2.5%** of the household income (with a separate overall family cap). 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. **Tax Tip.** The Health Care Act also provides for a *refundable* health insurance *premium assistance credit* to encourage low and middle income individuals to purchase health insurance, as discussed in the next segment.

Premium Assistance Tax Credits For Low And Middle Income Taxpayers. 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 qualify for 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.

New Penalty For Larger Employers That Fail To Provide Adequate Employee Health Coverage. The *Health Care Act*, **starting in 2014**, will generally require certain larger employers to either offer and contribute to their employees' *qualified* health insurance coverage, or pay a penalty. 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 penalty unless a 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 in 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 (regardless of how many employees are receiving a premium tax credit or cost-sharing reduction) multiplied by $166.67. For example, if an employer fails to offer minimum essential coverage and has 60 full-time employees, 10 of whom receive a tax credit for the year for enrolling in a state exchange plan, the employer will owe $166.67 per month for each employee over the 30-employee threshold, for a total monthly penalty of $5,000 [$166.67 x 30 (60 minus 30)]. **Planning Alert!** This new so-called *play-or-pay* penalty contains a host of technical provisions, which are far too lengthy to address in this letter. Please call our firm if you would like additional information.

Free Choice Vouchers. Congress recognized that some employers might offer a qualified employee a health insurance plan that required lower-paid employees to pay in more than they could afford in order to participate in the 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. This is a general overview of these technical rules, please contact our firm if you want additional information.

OTHER SELECTED MISCELLANEOUS PROVISIONS

The *Health Care Act* contains a variety of other miscellaneous tax changes, fees, and excise taxes with various effective dates, including: Gross Income Exclusion for Repayments under State Loan Programs for Health Care Professionals (Effective for amounts received after 2008); Annual Fee Imposed on Drug Manufacturers and Importers (Effective for calendar years beginning after December 31, 2010); Annual Fee Imposed on U.S. Health Insurance Providers (Generally effective for calendar years beginning after December 31, 2013); Excise Tax on Sales of Medical Devices (Effective for sales after December 31, 2012); Exchange-Participating Qualified Health

Plans Offered Through Cafeteria Plans (Effective for tax years beginning after December 31, 2013); Codification of Economic Substance Doctrine (Effective for transactions entered into after March 30, 2010); and others.

FINAL COMMENTS

Please call us if you are interested in a tax topic that we did not discuss. Tax law constantly changes due to new legislation, cases, regulations, and IRS rulings. Our firm closely monitors these changes and we will gladly discuss any current tax developments and planning ideas with you. Please note that the information contained in this material represents a general overview of tax developments and should not be relied upon without an independent, professional analysis of how any of these provisions may apply to a specific situation.

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