Tax Law Update

Patient Protection and Affordable Care Act (PPACA)

On June 28, 2012, the U.S. Supreme Court upheld the constitutionality of the Patient Protection and Affordable Care Act (PPACA), and its companion law, the Health Care and Education Reconciliation Act of 2010. As part of its primary purpose to facilitate health care reform, the PPACA includes key tax provisions that affect individuals. Now that the Supreme Court has ruled, individuals must prepare to comply with the requirements under PPACA. Some requirements are already in effect, while other provisions apply starting in 2013 or later.

KEY PROVISIONS AFFECTING INDIVIDUALS, TRUSTS AND ESTATES

Individual mandate

One of the key components of PPACA is a shared responsibility requirement for individuals. This has come to be known as the individual mandate. Broadly, this provision requires individuals to obtain minimum essential health coverage or pay a penalty starting in 2014. The individual mandate is a controversial linchpin to health care reform. However, the Supreme Court has determined that the individual mandate is a proper exercise of Congressional taxing power.

Some individuals are exempt from the individual mandate. These include individuals covered by Medicare and Medicaid, individuals with coverage under military health plans, undocumented individuals and others. The PPACA also imposes no penalty on individuals who cannot afford coverage including individuals whose family income is below the income tax filing threshold and individuals for whom the applicable premiums exceed 8% of family income. Individuals with employer-provided coverage generally are treated as having minimum essential coverage and are exempt from penalty.

Other provisions affecting individuals, trusts and estates

Along with the individual mandate, the provisions under PPACA affecting individuals are summarized in order of the effective dates as follows:

Changes already implemented

- Medical benefits for children under 27 years of age (effective 3/30/10)
- Dependent coverage until age 26 (for the first plan year beginning on, or after, 9/23/10)
- 10% Tanning excise tax (after 6/30/10)
- Increased tax on HSA/MSA distributions not used for medical expenses (distributions made after 12/31/10)

2013

Additional Medicare tax

A 0.9% tax is imposed on wages or self-employment income in excess of $200,000 ($250,000 for married filing joint) for taxable years after 12/31/12. Note that there is no employer match required for the additional 0.9% tax.

Medicare surtax on investment income

A 3.8% tax on investment income, including income from interest, dividends, capital gains, annuities, royalties, rents, and income from passive activities that is limited to the lesser of the taxpayer's investment income or the amount of the taxpayer's total gross income in excess of $200,000 ($250,000 for married filing joint). *Effective for tax years after 12/31/12.*

We are waiting for anticipated IRS regulations to confirm that qualified real estate professionals are not subject to this tax with respect to income from their real estate holdings.

Medicare tax on investment income – Trusts and Estates

For estates and trusts, the 3.8% Medicare surtax is equal to the lesser of undistributed "net investment income" or the excess of adjusted gross income in excess of the dollar amount at which the highest tax bracket begins for the taxable year which is expected to be approximately $12,000 for 2013.

The threshold at which the 3.8% surtax applies is much lower for estates and trusts which makes tax planning for next year critical.

Increased medical deduction threshold

The threshold for the itemized deduction for unreimbursed medical expenses is increased from 7.5% of modified adjusted gross income (MAGI) to 10% of MAGI for regular income tax purposes. This change is effective for tax years after 12/31/12 but is deferred to 2017 for taxpayers who are age 65 or older.

2014

Premium Assistance Tax Credit

This will be a refundable tax credit that eligible taxpayers can use to help cover the cost of health insurance premiums for individuals and families who purchase health insurance through a state health benefit exchange. (Effective for tax years after 12/31/13.)

Tax Planning Considerations - Individuals

Individuals whose adjusted gross income will be in excess of $200,000 (or $250,000 married filing joint) will need to plan ahead for the additional taxes to be imposed. Various planning actions should be considered to lessen the impact of these impending new taxes including:

Gain Harvesting

Capital gains rates will increase from 15% in 2012 to at least 18.8% in 2013 for taxpayers subject to the additional 3.8% Medicare tax. If the current 15% rate is allowed to expire, the 2013 rate is expected to increase to 23.8%. There may be opportunities to generate tax savings by harvesting gains in 2012 to take advantage of the lower tax rate. This decision will need to be weighed against the taxpayer's investment goals, transaction costs and other economic factors.

Installment Sale Elections

Taxpayers entering into installment sales may want to elect out of installment sale treatment in order to take advantage of the lower capital gains rates. The taxpayer's cash flow requirements, tax rates and other factors will need to be considered in making this decision.

Estimated taxes and payroll withholding

Due to the increased tax on wages and self-employment income over the $200,000 threshold ($250,000 for married filing joint), self-employed taxpayers may need to increase their estimated payments in 2013. Also, taxpayers who have wages from multiple employers or married taxpayers whose wages are separately below the threshold but whose combined wages are above $250,000 may need to increase their withholding to avoid having a larger tax liability when they file their tax returns.

2012 Roth Conversions

Distributions from traditional IRAs are included in a taxpayer's modified adjusted gross income and could increase a taxpayer's MAGI over the threshold and trigger these new taxes. Since distributions from Roth IRAs do not increase MAGI, this would yield a benefit similar to gain harvesting, by realizing gains earlier but at lower capital gains rates.

Sale of a principal residence

Net gains on the sale of a principal residence will also be subject to the 3.8% tax on investment income; however it is important to note that the sale of a principal residence will still be non-taxable for the first $250,000 of capital gain ($500,000 for married filing joint).

Most people will probably not pay the 3.8% tax on the gain from the sale of a principal residence.

Portfolio Balancing

Taxpayers should consult with their investment advisors regarding whether the increased tax on investment income will require a revised balance of investment assets between growth assets, investments paying interest and dividends, life insurance, rental real estate, oil and gas, tax deferred annuities, and tax-exempt bonds in order to achieve the most favorable after tax returns.

Charitable trusts

Taxpayers with appreciated assets such as stocks or real estate who are planning significant charitable giving may want to consider charitable remainder trusts or charitable lead trusts as an estate planning strategy which may also defer recognition of gains or reduce investment income subject to the surtax by reducing MAGI depending on the type of trust.

S Corporation Election

For those that own businesses structured as a C Corporation or Partnership, the 0.9% additional Medicare tax will likely apply for those entities that have profits in excess of $200,000 ($250,000 for married filing joint). This is because as a C Corporation the profits are typically drawn out of the business as wages that are subject to the 0.9% additional Medicare tax. The share of profits allocated to an active member of a Partnership is characterized as self-employment income and as such are also subject to the 0.9% additional Medicare tax.

What to do? Consider changing to an S Corporation tax structure. The profits of an S Corporation are not currently subject to the 0.9% additional Medicare tax on wage/self-employment income or the 3.8% additional Medicare tax on net investment income.

A tax structure change has major tax, financial and non-financial implications and the decision to make such a change should only be made after review of the implications with your tax and financial advisors.

Tax Planning Considerations – Estates and Trusts

Due to the lower threshold at which these taxes kick in for estates and trusts, careful planning is required to make sure that income is not unnecessarily subjected to the surtax.

Choice of Accounting Year

The choice of the tax accounting year-end for estates will impact which year the income in the estate will first be subject to the 3.8% surtax.

Distributions

Because the surtax is only applied at the trust and estate level on undistributed income, the timing of distributions will impact the taxes of both the trust (for complex trusts) or estate and the beneficiaries. If the beneficiary's adjusted gross income is below $200,000 ($250,000 for MFJ) before the income from the estate or trust is considered, some of the distribution may be excluded from taxation by the higher thresholds at the individual level. Trust fiduciaries can take advantage of the "65 day rule" to treat distributions made within 65 days after year-end as if they were made in the previous year if it is determined that this will reduce overall tax liability.

KEY PROVISIONS AFFECTING BUSINESSES

2010

Small employer health insurance credit

Small businesses – defined as businesses with 25 or fewer employees and average annual wages (not including owners) of $50,000 or less – are eligible for a credit for tax years 2010 through 2013, of up to 35 percent of non-elective contributions the businesses make on behalf of employees for health insurance premiums. The credit is scheduled to increase to 50 percent after 2013 but will terminate after 2015. In tax years that begin after 2013, an employer must participate in an insurance exchange (state sponsored insurance markets to be created under the PPACA) in order to claim the credit, and other modifications and restrictions on the credit apply.

Enhanced simple cafeteria plan rules

An eligible small employer (generally with 100 or fewer employees) is provided with a safe harbor from the nondiscrimination requirements for cafeteria plans as well as from the nondiscrimination requirements for specified qualified benefits under a cafeteria plan. As a result, the provisions allow small employers to retain potentially discriminatory benefits for highly compensated and key employees while allowing other employees to enjoy the benefits of a cafeteria plan. *(Effective for tax years beginning after December 31, 2010*.)

2013

$500,000 compensation deduction limit for health insurance issuers

Covered health insurance providers (certain insurance companies) are not allowed a compensation deduction for an "applicable individual" including officers, employees, directors and other workers or service providers such as consultants. *(Effective for tax years beginning after December 31, 2012.)*

Changes to retiree prescription drug subsidy

The amount otherwise allowable as a deduction for retiree prescription drug expenses will be reduced by the amount of the excludable subsidy payments received. Previously, employers were allowed to disregard federal subsidies received for providing a qualified retiree prescription drug plan in calculating deductions for such expenses. *(Effective for tax years beginning after December 31, 2012*.)

2014

Shared responsibility payment for employers regarding health coverage
Applicable large employers (generally those with 50 or more full-time equivalent employees) may be subject to a "shared responsibility" payment of up to $2,000 per employee if any full-time employee is certified to receive an applicable premium tax credit or cost-sharing reduction payment beginning after December 31, 2013.

Generally, this may occur where either:

- the employer does not offer to its fulltime employees (and their dependents) the opportunity to enroll in minimum essential coverage under an eligible employer-sponsored plan; or
- the employer offers its full-time employees (and their dependents) the opportunity to enroll in minimum essential coverage under an eligible employer-sponsored plan that either is unaffordable relative to an employee's household income or does not provide minimum value (that pays at least 60 percent of benefits).

2018

Excise tax on high-cost health care coverage
Employer-sponsored health coverage that exceeds a threshold amount is scheduled to be subject to a 40-percent excise tax. The dollar limits for determining the tax thresholds are $10,200 (for 2018) multiplied by the health cost adjustment percentage for an employee with self-only coverage; and $27,500 (for 2018) multiplied by the health cost percentage for an employee with coverage other than self-only coverage. *(Effective starting in 2018.)*

New Reporting Requirements

In addition to the tax and insurance related provisions of the act, employers will have to comply with the following reporting requirements.
Disclosure of cost of employer-sponsored coverage on Form W-2 (mandatory after 2011)
Employers are required to disclose on each employee's annual Form W-2 the value of the employee's health insurance coverage sponsored by the employer. Reporting is for informational purposes only. The IRS also provided transition relief for small employers. For 2012 W-2s (and W-2s issued in later years, unless and until further guidance is issued), an employer is not subject to reporting for any calendar year if the employer is required to file fewer than 250 W-2s for the preceding calendar year.
Reporting requirements for sponsors of health care coverage (for calendar years after 2013)
The PPACA requires every health insurance issuer, sponsor of a self-insured health plan, government agency that administers government-sponsored health insurance programs and other entities that provide minimum essential coverage to file an annual return reporting information for each individual for whom minimum essential coverage is provided. Additionally, every applicable large employer that is required to meet the shared employer responsibility requirements of the PPACA during a calendar year must file a return with the IRS reporting the

terms and conditions of the health care coverage provided to the employer's full-time employees for the year.

Employers and individuals must prepare for the sweeping changes in health care in coming years. The Supreme Court's upholding of the PPACA clears the way for implementation of the new law. We can assist you in the steps you need to take in the coming months and years.
If you have any questions on healthcare reform or the Supreme Court's decision, please contact our office.

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