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2010

HEALTH CARE ACT OF 2010

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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.

To help you locate items that will require the most immediate attention, we have generally organized our discussions in this letter in effective date order, using the following headings:

- Highlights Of The Health Care and HIRE Acts
- Selected Provisions First Effective In 2010
- Selected Provisions First Effective In 2011
- Selected Provisions First Effective In 2012
- Selected Provisions First Effective In 2013
- Selected Provisions First Effective In 2014

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.

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 *tax provisions* contained in this new legislation and to *tax planning* that might be advisable in the relatively near future. We begin with *a general overview of the effective dates* of the more important changes, *followed by a more detailed discussion* of selected tax changes that might warrant your immediate attention.

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 and 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 Section 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 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. 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 owner of the employer, **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 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.

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.

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.

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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. After reading the following requirements for the credit, if you think that your business may qualify, please call our office and we will help you determine whether your business qualifies and the amount of credit you can expect.

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' familes). **If you think that your business may qualify, please call our office and we will help you determine whether your business qualifies and the amount of credit you can expect.**

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. If you need additional details, please call our office.

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. 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.

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%).

> **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.

Cost of Employer-Sponsored Health Coverage Included on W-2. For tax years beginning after Dec. 31, 2010, an employer must disclose on each employee's annual Form W-2 the value of the employee's health insurance coverage sponsored by the employer. If an employee enrolls in employer-sponsored health insurance coverage under multiple plans, the employer must disclose the aggregate value of all such health coverage (excluding the value of a health flexible spending arrangement (FSA)). For example, if an employee enrolls in employer sponsored health insurance coverage under a major medical plan, a dental plan, and a vision plan, the employer must report the total value of the combination of all of these health related insurance policies. For this purpose, employers generally use the same value for all similarly situated employees receiving the same category of coverage (such as single or family health insurance coverage). The reporting requirement for the cost of employer-sponsored coverage doesn't apply to coverage for amounts contributed by an employer to: (1) any Archer medical savings account of an employee or the employee's spouse; or (3) to a health savings account of an employee or the employee's spouse. In addition, reporting isn't required for the amount of any salary reduction contributions to a flexible spending arrangement.

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. The current definition of property includes materials, supplies and other tangible goods used in a trade or business.

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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.

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.

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 the 2.9% 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.

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.

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

- **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.

Planning Alert! 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 office 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.

- **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 capital losses 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!

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. 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.** Starting in 2014, 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.

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.

> **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 office if you would like additional information.

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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