

TAX NEWSLETTER

2010 MID YEAR TAX LAW UPDATE

July 28, 2010

Dear Clients and Other Friends-

Times are interesting in the tax business. We know Congress can not leave the tax laws alone in normal times. Now we have them trying various tax tactics to revive the economy. Throw in the one year elimination of the estate tax to come back in full force on January 1, 2011; add the expiration of the Bush era tax cuts; mix it all thoroughly with the upcoming congressional elections; sprinkle liberally (all puns intended) with the healthcare legislation and you have the recipe for some very challenging tax laws. For dessert they have to figure out how to address the growinggggg deficit.

If our tax laws were used simply to raise tax revenue, I would not have a job. However, they are used to social engineer, reward those who have been nice, punish those who have been bad (watch out BP), stimulate the economy; stimulate specific industries, etc. etc. So, I continue to have something to write about.

I last wrote about the American Recovery and Reinvestment Act of 2009. Since then there have been the Worker, Homeownership, and Business Assistance Act of 2009, the Hire Act of 2010, the 2010 Health Care Act and the 2010 Health Care Reconciliation Act. Today I am going to cover some of the highlights of those acts. I can almost guarantee we will have more tax acts before the end of the year to address the expiring Bush tax cuts including the estate tax. I will cover those in later newsletters.

Some of the more material changes will not take effect for a couple years. However it is important that you be aware of them.

Individual tax changes:

Individual health care mandate. We now have an “individual mandate”—a requirement that U.S. citizens and legal residents have qualifying health coverage or be subject to a tax penalty. Under the new law, those without qualifying health coverage will pay a tax penalty of the greater of: (a) \$695 per year, up to a maximum of three times that amount (\$2,085) per family, or (b) 2.5% of household income over the threshold amount of income required for income tax return filing. The penalty will be phased in according to the following schedule: \$95 in 2014, \$325 in 2015, and \$695 in 2016 for the flat fee or 1.0% of taxable income in 2014, 2.0% of taxable income in 2015, and 2.5% of taxable income in 2016. Beginning after 2016, the penalty will be increased annually by a cost-of-living adjustment.

Premium assistance tax credits for purchasing health insurance. An offset to help the above mandate is a provision for tax credits to low and middle income individuals and families for the purchase of health insurance. For tax years ending after 2013, the new law creates a refundable tax credit (the “premium assistance credit”) for eligible individuals and families who purchase health insurance through an exchange.

Higher Medicare taxes on high-income taxpayers. Starting in 2013 single people earning more than \$200,000 and married couples earning more than \$250,000 will be taxed an additional 0.9% Medicare tax (2.35% in total) on the excess over those base amounts for Medicare tax. Employers will collect the extra 0.9% on wages exceeding \$200,000 just as they would withhold Medicare taxes and remit them to the IRS. Companies wouldn't be responsible for determining whether a worker's combined income with his or her spouse made them subject to the tax. Instead, some employees will have to remit additional Medicare taxes when they file income tax returns, and some will get a tax credit for amounts overpaid. Self-employed persons will pay 3.8% on earnings over the above amounts (2.9% previously). It should also be noted that the \$200,000/\$250,000 thresholds are not indexed for inflation, so it is likely that more and more people will be subject to the higher taxes in coming years. Anytime a tax threshold is not indexed for inflation, it creates an automatic tax increase each year. The AMT is a great example.

Medicare tax extended to investments. Beginning in 2013, a Medicare tax will, for the first time, be applied to investment income. A new 3.8% tax will be imposed on net investment income of single taxpayers with AGI above \$200,000 and joint filers over \$250,000 (again not indexed for inflation). Net investment income is interest, dividends, royalties, rents, gross income from a trade or business involving passive activities, and net gain from disposition of property (other than property held in a trade or business). Net investment income is reduced by properly allocable deductions to such income. However, the new tax won't apply to income in tax-deferred retirement accounts such as 401(k) plans. Also, the new tax will apply only to income in excess of the \$200,000/\$250,000 thresholds. So if a couple earns \$200,000 in wages and \$100,000 in capital gains, \$50,000 will be subject to the new tax. Because the new tax on investment income won't take effect for three years that leaves more time for Congress and the IRS to tinker with it. So we can expect lots of refinements and "clarifications" between now and when the tax is actually rolled out in 2013.

Floor on medical expenses deduction increased from 7.5% of adjusted gross income (AGI) to 10%. Under current law, taxpayers can take an itemized deduction for unreimbursed medical expenses for regular income tax purposes only to the extent that those expenses exceed 7.5% of the taxpayer's AGI. The new law raises the floor beneath itemized medical expense deductions from 7.5% of AGI to 10%, effective for tax years beginning after Dec. 31, 2012. The AGI floor for individuals age 65 and older (and their spouses) will remain unchanged at 7.5% through 2016.

Limit reimbursement of over-the-counter medications from HSAs, FSAs, and MSAs. The new law excludes the costs for over-the-counter drugs not prescribed by a doctor from being reimbursed through a health reimbursement account (HRA) or health flexible savings accounts (FSAs) and from being reimbursed on a tax-free basis through a health savings account (HSA) or Archer Medical Savings Account (MSA), effective for tax years beginning after Dec. 31, 2010.

Increased penalties on nonqualified distributions from HSAs and Archer MSAs. The new law increases the tax on distributions from a health savings account or an Archer MSA that are not used for qualified medical expenses to 20% (from 10% for HSAs and from 15% for Archer MSAs) of the disbursed amount, effective for distributions made after Dec. 31, 2010.

Limit health flexible spending arrangements (FSAs) to \$2,500. An FSA is one of a number of tax-advantaged financial accounts that can be set up through a cafeteria plan of an employer. An FSA allows an employee to set aside a portion of his or her earnings to pay for qualified expenses as established in the cafeteria plan, most commonly for medical expenses but often for dependent care or other expenses. Under current law, there is no limit on the amount of contributions to an FSA. Under the new law, however, allowable contributions to health FSAs will be capped at \$2,500 per year, effective for tax years beginning after Dec. 31, 2012. The dollar amount will be indexed for inflation after 2013.

Dependent coverage in employer health plans. Effective on the enactment date, the new law extends the general exclusion for reimbursements for medical care expenses under an employer-provided accident or health plan to any child of an employee who has not attained age 27 as of the end of the tax year. Also, self-employed individuals are permitted to take a deduction for the health insurance costs of any child of the taxpayer who has not attained age 27 as of the end of the tax year.

Liberalized adoption credit and adoption assistance rules. For tax years beginning after Dec. 31, 2009, the adoption tax credit is increased by \$1,000, made refundable, and extended through 2011. The adoption assistance exclusion is also increased by \$1,000.

Business tax changes:

Payroll tax holiday and up-to-\$1,000 credit for employers who hire unemployed workers. To help stimulate the hiring of workers by the private sector, the new law exempts any private-sector employer that hires a worker who had been unemployed for at least 60 days from having to pay the employer's 6.2% share of the Social Security payroll tax on that employee for the remainder of 2010. A company could save a maximum of \$6,621 if it hired an unemployed worker and paid that worker at least \$106,800—the maximum amount of wages subject to Social Security taxes—by the end of the year. As an additional incentive, for any qualifying worker hired under this initiative that the employer keeps on payroll for a continuous 52 weeks, the employer is eligible for an additional non-refundable tax credit of up to \$1,000 after the 52-week threshold is reached, to be taken on their 2011 tax return. In order to be eligible, the employee's pay in the second 26-week period must be at least 80% of the pay in the first 26-week period.

Extension of enhanced small business expensing. The new law gives a one-year lease on life to enhanced expensing rules, which allow qualifying businesses the option to currently deduct the cost of business machinery and equipment, instead of recovering it via depreciation over a number of years. For tax years beginning in 2010, the maximum amount that a business may expense is \$250,000, and the expensing election begins to phase out when a business buys more than \$800,000 of expensing-eligible assets. These dollar limits are the same as those that were in effect for 2008 and 2009. Had the HIRE Recovery Act not been passed and signed into law, these dollar limits would have dropped this year to \$134,000 and \$530,000 respectively.

Tax credits to certain small employers that provide insurance. The new law provides small employers with a tax credit (i.e., a dollar-for-dollar reduction in tax) for non-elective contributions to purchase health insurance for their employees. The credit can offset an employer's regular tax or its alternative minimum tax (AMT) liability. This is a complicated credit so I will cover some of the key issues in more depth.

Small business employers eligible for the credit. To qualify, a business must offer health insurance to its employees as part of their compensation and contribute at least half the total premium cost. The business must have no more than 25 full-time equivalent employees ("FTEs"), and the employees must have annual full-time equivalent wages that average no more than \$50,000. However, the full amount of the credit is available only to an employer with 10 or fewer FTEs and whose employees have average annual full-time equivalent wages from the employer of less than \$25,000.

Years the credit is available. The credit is initially available for any tax year beginning in 2010, 2011, 2012, or 2013. Qualifying health insurance for claiming the credit for this first phase of the credit is health insurance coverage purchased from an insurance company licensed under state law. For tax years beginning after 2013, the credit is only available to an eligible small employer that purchases health insurance coverage for its employees through a state exchange and is only available for two years. The maximum two-year coverage period does not take into account any tax years beginning in years before 2014. Thus, an eligible small employer could potentially qualify for this credit for six tax years. under the second phase.

Calculating the amount of the credit. For tax years beginning in 2010, 2011, 2012, or 2013, the credit is generally 35% (50% for tax years beginning after 2013) of the employer's non-elective contributions toward the employees' health insurance premiums. The credit phases out as firm-size and average wages increase. Tax-exempt small businesses meeting these requirements are eligible for payroll tax credits of up to 25% for tax years beginning in 2010, 2011, 2012, or 2013 (35% in tax years beginning after 2013) of the employer's non-elective contributions toward the employees' health insurance premiums.

You will need mental health coverage by the time you figure out if you qualify.....

Most small businesses exempted from penalties for not offering coverage to their employees.

Although the new law imposes penalties on certain businesses for not providing coverage to their employees (so-called "pay or play"), most small businesses won't have to worry about this provision because employers with fewer than 50 employees aren't subject to the "pay or play" penalty. For businesses with at least 50 employees, the possible penalties vary depending on whether or not the employer offers health insurance to its employees. If it does not offer coverage and it has at least one full-time employee who receives a premium tax credit, the business will be assessed a fee of \$2,000 per full-time employee, excluding the first 30 employees from the assessment. So, for example, an employer with 51 employees who doesn't offer health insurance to his employees will be subject to a penalty of \$42,000 (\$2,000 multiplied by 21). Employers with at least 50 employees that offer coverage but have at least one full-time employee receiving a premium tax credit will pay \$3,000 for each employee receiving a premium credit (capped at the amount of the penalty that the employer would have been assessed for a failure to provide coverage, or \$2,000 multiplied by the number of its full-time employees in excess of 30). These provisions take effect Jan. 1, 2014.

The "Cadillac tax" on high-cost health plans. Starting in 2018, the new law places an excise tax on high-cost employer-sponsored health coverage (often referred to as "Cadillac" health plans). This is a 40% excise tax on insurance companies, based on premiums that exceed certain amounts. The tax is not on employers themselves unless they are self-funded (this typically occurs at larger firms). However, it is expected that employers and workers will ultimately bear this tax in the form of higher premiums passed on by insurers.

As a side note, people are always interested in their chances of being audited (not that anybody plays the audit lottery....). IRS has issued its annual data book, which provides statistical data on its fiscal year 2009 activities, including how many tax returns it examines (audits), and what categories of returns it focuses its resources on. Of the 138,788,744 total individual income tax returns in calendar year 2008, 1,425,888 (1%) were audited. For business returns other than farm returns showing total gross receipts of \$100,000 to \$200,000, 4.2% of returns were audited. For business returns other than farm returns showing total gross receipts of \$200,000 or more, 3.2% of returns were audited. For returns showing total positive income of \$200,000 to \$1 million, 2.3% of returns not showing business activity were audited, and 3.1% of returns showing business activity were audited.

I have hit on some of the highlights of the recent tax laws. If you need more information on these changes, or other changes I have not covered, please contact me.

Tim

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