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CPA Client Bulletin

Smart Tax, Business & Planning Ideas *from your* Trusted Business Advisor℠

The Coming Cost of Health Insurance

July 2010

Two new laws—the Patient Protection and Affordable Care Act of 2010 and the Health Care and Education Tax Credits Reconciliation Act of 2010—have been passed by Congress and signed by President Obama. As described in the June 2010 issue of *CPA Client Bulletin*, some provisions take effect in 2010.

Generally, however, the new legislation will phase in over the next decade. In 2014, one of the major provisions of the new legislation will take effect: most people will be required to have health insurance.

Three primary ways to fulfill this requirement would be enrollment in Medicare or Medicaid, coverage by an employer-sponsored health plan, or purchase of any health insurance plan or policy marketed to individuals as long as the plan primarily covers medical benefits. You can't comply with this future legislative requirement, however, by buying long-term care insurance.

Paying the penalty

What if 2014 arrives and you have no health insurance? You'll have to pay a penalty on your federal income tax return. This penalty will be the greater of (1) a flat dollar amount or (2) a percentage of your household income, both of which will be phased in over the course of three years. In 2014, the flat dollar amount will be $95 per adult and the income percentage will be 1%. In 2015, the penalty increases to $325 per adult for the flat dollar amount and 2% for the income percentage amount. By 2016, the penalty will be fully phased in with a flat dollar amount of $695 per adult and an income percentage of 2.5%. In subsequent years, the $695 number will be indexed for inflation while the income percentage will remain at 2.5%

Each year, the flat dollar amount for uninsured minors will be one-half the adult fine. The flat dollar amount per family is capped at three times the adult fine for the year.

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Revenue Raisers

The new health insurance legislation contains more than $400 billion in new taxes on employers and individuals.

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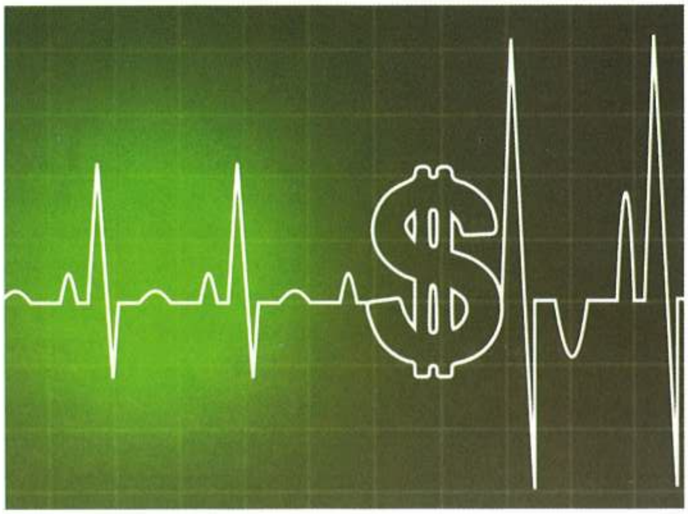

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Example 1: In 2014, Jim Smith decides not to carry any health insurance for himself, his wife, and his two young children. His income for the year is $50,000.

The Smiths' flat dollar penalty amount is $285 for two adults and two minors ([$95 × 2] + [$47.50 × 2]) in 2014. Their income percentage amount is $500: 1% of his 2014 income. Because the income-based penalty is greater, they would owe a tax penalty of $500 in 2014 for not having health insurance.

Example 2: Assume the Smiths do not buy health insurance in 2016, and their income remains the same. Their tax penalty would be the greater of (1) a flat dollar amount of $2,085, for two adults at $695 per adult and an additional $695 for the two minors combined; or (2) $1,250, which is 2.5% of $50,000. Thus, the Smiths would owe a tax penalty of $2,085 in 2016.

Month by month

The tax penalty for not buying health insurance will be applied on a monthly basis. Suppose the Smiths decide to buy family coverage halfway through 2016. As explained in example 2, their full year tax penalty would have been $2,085; however, because the Smiths have insurance for half the year, they will owe half the full year tax penalty, $1,042.50.

Weighing the tradeoff

Some people might decide not to buy health insurance and pay the tax penalty instead. Such choices may be especially common in 2014 and 2015 while the tax penalties are being phased in, but some people may opt for going without health insurance in 2016 and beyond.

For example, a family with $100,000 in income probably would owe a $2,500 penalty in 2016. Assuming that the family is in good health and doctor visits are rare, their annual health care costs, including the tax penalty, might be much less than the cost of buying health insurance. If they do get sick or injured, they can buy health insurance then. As of 2014, legislation prohibits insurance companies from denying applicants because of pre-existing conditions.

When this provision of the new legislation takes effect, you can decide whether to buy coverage or pay the penalty. Your choice probably will depend on your family's health and the prevailing rates of health insurance premiums. Looking ahead, our office will be able to go over the numbers with you so that you can make an informed decision. ■

Did You Know?

Total U.S. retirement assets rose 18% to $9.3 trillion in 2009, up from $7.9 trillion in 2008. Assets in 401(k) plans, which account for 35% of all retirement assets, rose 20% to $2.3 trillion in 2009, up from $1.9 trillion in 2008.

Source: Spectrem Group

Tax Credits May Help Pay for Health Insurance

Starting in 2014, the law will require most individuals and families in the United States to have health insurance. To help low and middle income consumers purchase the required coverage, the federal government will provide premium assistance tax credits. These tax credits are refundable. This means if someone qualifies for tax credits that exceed his or her tax obligation, the federal government will send the excess to the insurance company providing the coverage, as explained in example 1.

RECEIPTS
PERSONAL
LICENSES
INSURANCE
Health Benefits
FINANCING

Who gets the tax credits?

These tax credits will be provided to individuals and families with household income up to 400% of the federal poverty level (FPL) who purchase a qualified health plan on an insurance exchange. Currently, the FPL in the 48 contiguous states and D.C. (the continental United States) is annual income up to about $11,000 for an individual and $22,000 for a family of four (the FPL is higher for residents of Alaska and Hawaii). Therefore, if this portion of the new law were to take effect today, tax credits would be provided to individuals in the continental United States with income up to approximately $44,000 and to families with income up to $88,000. Those numbers may be higher in 2014.

How large will the credits be?

Premium assistance tax credits will drop as income increases. Using today's FPL, a family of four in the continental United States with income of approximately $29,000 or less (about $14,500 for individuals) would get the maximum tax credit. A family with income of approximately $66,000 to $88,000 ($33,000 to $44,000 for individuals) would get the smallest tax credit.

To determine the credit amount, a certain percentage of household income will be deemed to go toward health insurance. The percentage increases with income, from 2% to 9.5%, under the new legislation. If the price of a standard policy exceeds that amount, tax credits will make up the difference.

Example 1: Ellie and Greg Larsen are married with two young children, living in Ohio. In 2014, their household income is $40,000, which is 150% of the FPL that year. Under the new laws, the Larsens are expected to spend 4% of their income on health insurance, $1,600 in 2014.

A standard policy for a family of four where the Larsens live costs $1,000 a month. That's $12,000 a year. Therefore, they would receive a $10,400 tax credit: the assumed $12,000 cost of coverage minus the $1,600 the Larsens are expected to spend. If the Larsens end up owing only $2,400 in federal income tax, that tax would be completely offset by the $10,400 credit and the excess $8,000 would be paid to the Larsens' health insurance company.

Families with income of 300% to 400% of the FPL will go through a similar calculation, except that they will be expected to pay 9.5% of their income on health insurance. A family with income of $80,000, for example, would be expected to spend $7,600 on health insurance. If a standard policy costs $12,000 a year, this family would get a $4,400 tax credit.

Complicating factor

Premium assistance tax credits certainly will reduce tax obligations for many people. At the same time, they may increase effective marginal tax rates for recipients of the credits. As income increases, credits may decline.

Example 2: In the previous example, the Larsens have income of $40,000 and a tax credit of $10,400. Suppose their younger child starts school full time, so Ellie (who has been a homemaker) has an opportunity to go back to work at a salary of $60,000. This additional income might remove their eligibility for the tax credit. Not only would Ellie's earned income be subject to income tax, it would cost them a $10,400 tax credit, an effective tax of more than 17% on her new income, in addition to regular income tax.

For many people, such calculations may affect decisions on whether to go back to work, take extra freelance assignments, work overtime, and so on. Even if your income is over the threshold for such tax credits, your adult children and grandchildren may have to include premium assistance calculations in their plans. ■

A Future Tax May Hit Unearned Income

Although major provisions of the new health insurance legislation such as mandatory coverage and premium assistance won't take effect until 2014, you may be affected by significant tax increases before then. One of these tax increases is a 3.8% tax (described as a Medicare contribution) on some taxpayers' unearned income, starting in 2013.

Two thresholds

This 3.8% tax will affect taxpayers whose modified adjusted gross income (MAGI) exceeds certain amounts. MAGI, for this purpose, will be the adjusted gross income (AGI) you report on the bottom of page 1 of IRS Form 1040 or Form 1040A (on line 4 of Form 1040EZ), plus any foreign income you exclude in calculating AGI. If your MAGI is no more than $200,000 as a single filer, or no more than $250,000 on a joint return, you will not be subject to this 3.8% tax. (These two MAGI thresholds will not be indexed for inflation.)

If your MAGI is over the relevant threshold, you'll probably owe the 3.8% tax. Here's how to calculate your obligation:

1. Determine your **net investment income.** For a given calendar year, add up your taxable interest, dividends, capital gains, rents, royalties, ordinary income

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Trusted Advice

Taking Estates and Trusts

- ▲ In 2013, the new 3.8% tax on unearned income also will apply to estates and trusts.
- ▲ In 2010, estate and trust income over $11,200 is taxed at the highest income tax rate, which is 35%.
- ▲ By 2013, the 3.8% surtax may also apply to estate and trust income over approximately $12,000.
- ▲ Under current law, the top income tax rate in 2013 will be 39.6%. If a trust has $13,000 of taxable income that year, all from investment income, and the 39.6% tax rate starts at $12,000, this trust would owe a total of 43.4% (39.6% plus 3.8%) on $1,000 of investment income.

and capital gains from passive activities (such as rental real estate activities) or financial instrument or commodities trading businesses, and taxable payouts from annuities. Then subtract any deductions allocated to that income, such as interest on margin loans.

2. Determine the extent to which your **MAGI** exceeds the relevant threshold.
3. You will owe 3.8% tax on the lower number, (1) or (2).

Do the math

Some examples will illustrate the above calculation.

Example 1: John Jones, a single filer, has MAGI of $220,000 in 2013. His net investment income is $50,000. John's MAGI is over the $200,000 threshold by $20,000. Here, John's MAGI threshold overage of $20,000 is less than John's investment income of $50,000. Thus, John will owe a 3.8% tax on $20,000, $760.

Example 2: Amelia and Bart Dugan have MAGI of $310,000 in 2013. Their net investment income is $50,000, the same as John Jones. However, the Dugans are $60,000 over the $250,000 threshold for their joint MAGI. The Dugans' investment income of $50,000 is less than their income threshold overage of $60,000. Therefore, the Dugans will owe the 3.8% tax on all $50,000 of their net investment income, $1,900.

Tax trimming tactics

Two ways exist for high income taxpayers to avoid or reduce their exposure to this 3.8% tax. First, you can trim your net investment income. You might invest in tax-exempt municipal bonds or no dividend growth stocks, for example. The less investment income you have, the lower your potential tax obligation.

Second, you can minimize your MAGI. Tax deductible contributions to retirement plans, for example, may be able to hold your MAGI below or modestly above the relevant threshold and reduce the amount you'll owe under this 3.8% tax.

As mentioned, this tax won't be effective until 2013. Therefore, you have more than two years to arrange tax reduction strategies. In 2010, though, you might consider a Roth IRA conversion as a means of reducing the amount of this 3.8% tax you'll owe in the future.

With a Roth IRA, distributions are completely tax free after five years and after age 59½. Depending on your age, you might be able to take tax-free Roth IRA distributions as early as 2015 if you convert in 2010. (If you previously had a Roth IRA, the conversion starts a new five-year clock so you will have to wait those five years until investment earnings from the converted dollars can come out tax free.) Tax-free Roth IRA distributions are not considered investment income and will not boost your MAGI. Therefore, they will not trigger the 3.8% tax in 2013 and later years.

Converting to a Roth IRA does trigger income tax. If you convert in 2010, you'll pay tax at today's rates, no higher than 35%. That may be better than taking taxable distributions or converting in the future when you may owe higher income tax rates and when distributions or conversions might raise your MAGI and thus cause a 3.8% surtax as well.

What's more, you'll get the greatest advantage from a Roth IRA conversion if you pay the resulting tax from non-IRA funds. If you draw down your taxable investments to pay the tax, you may have less investment income in the future and thus owe a smaller amount of the new 3.8% tax. Our office will be able to help you begin planning for the coming tax on unearned income. ■

High Earners Face a New Tax

In 2013, when a new tax on unearned income takes effect (see "A Future Tax May Hit Unearned Income" in this issue), some workers also will face a new tax on their earned income. This will be a payroll tax on individuals with earned income over $200,000. Married couples with earned income over $250,000 also will be affected.

Under current law, employees see a Medicare tax of 1.45% taken from each paycheck. Employers pay a matching 1.45% for a total of 2.9%. This payroll tax applies to all earnings, with no ceiling.

As of 2013, employees also will pay a 0.9% Medicare tax on earnings over the threshold amounts. Employers will not have to pay this additional tax.

Example 1: Paula Franklin earns $305,000 in 2013. Her Medicare tax will be 1.45% of her first $250,000 in earnings and 2.35% (1.45% + 0.9%) of her remaining $55,000 of earnings. Her employer's contribution remains at 1.45% of Paula's $305,000 in total earnings.

This 0.9% tax, like the 3.8% tax on some unearned income, has a marriage penalty that may affect dual-income couples.

Example 2: Steve Matthews and Lynn Baxter are not married in 2013. They each earn $190,000 a year. Neither owes the 0.9% extra Medicare tax. Steve and Lynn get married in 2014 and file a joint tax return for that year. Assuming they have the same earned income, Steve and Lynn combine for $380,000 in earnings, $130,000 over the limit. At a 0.9% rate, they'll owe $1,170 in extra tax in 2014.

Some taxpayers, such as S corporation shareholders, attempt to minimize earned income in order to reduce payroll taxes. Cash might flow through to S corporation shareholders as profits rather than wages. Such efforts may become more appealing when payroll taxes increase in 2013. If you think you might benefit from such a strategy, our office can help you set acceptable levels of compensation. ■

Additional Tax Provisions

Several other provisions of the new health insurance legislation have tax implications. They include the following:

- **Employer coverage.** Businesses with 50 or more full time employees must offer health insurance plans. If they don't, they'll owe a tax. To calculate the tax, the company will subtract 20 from its number of full time employees, then multiply the difference by $2,000 a year. Effective date: 2014.
- **Cadillac plans.** This phrase applies to expensive employer-provided health plans with extremely generous benefits. The new legislation deems a plan that costs more than $10,200 a year (for individuals) or $27,500 a year (for family coverage) a high cost plan and imposes a 40% tax on costs above those amounts. The employer, the plan administrator, or the insurer will owe the tax, depending on the type of plan. Effective date: 2018.

Congress inserted this provision to limit the growth of lavish group health insurance benefits. Such benefits are tax free to employees. Lawmakers hope that employers will pay cash compensation instead—compensation that is subject to income tax.

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Trusted Advice

Health Savings Accounts: Still Viable

- To have a health savings account (HSA), you must have high deductible health insurance. With a high deductible, your premiums may be relatively low.
- With qualifying health insurance, you can make a tax deductible contribution to an HSA. You can make a one-time contribution or multiple contributions over the course of a year, up to the HSA limit.
- In 2010, the maximum HSA contribution is $3,050 for an individual and $6,150 for a family plan. The family contribution can be divided between spouses.
- If you're 55 or older, the maximum contributions in 2010 are $4,050 for an individual and $7,150 for a family.
- Investment earnings inside the HSA aren't taxed.
- HSA withdrawals are tax free if the money is spent on health care.
- The new health insurance legislation prohibits tax-free withdrawals to pay for over-the-counter drugs, starting in 2011. This mandate applies to HSAs as well as to flexible spending arrangements (FSAs).
- Also in 2011, the penalty tax on nonmedical deductions from HSAs increases from 10% to 20%.

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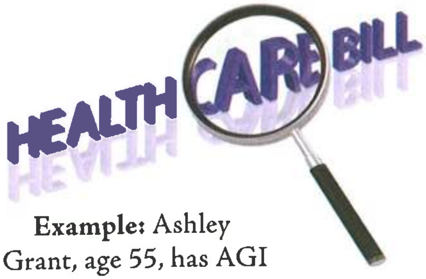
- **Income tax deductions.** Taxpayers who itemize deductions on their income tax returns can deduct medical expenses that exceed 7.5% of their adjusted gross income (AGI). That threshold will rise to 10% of AGI. Effective date: 2013 (The threshold remains 7.5% in the years 2013 through 2016 for taxpayers who are age 65 and older or reach age 65 before the end of the tax year.)
- **IRA distributions.** Taxpayers who take money from their IRAs before age 59½ generally owe a 10% penalty in addition to regular income tax. There are several exceptions to this penalty, including amounts spent on medical care that exceed 7.5% of AGI.



Example: Ashley Grant, age 55, has AGI of $100,000 and spends $12,000 this year on unreimbursed medical expenses. Her 7.5% threshold is $7,500 so the excess is $4,500. Thus, Ashley can take up to $4,500 from her IRA this year without owing the 10% penalty.

Under the new legislation, the threshold will rise to 10% of AGI. For Ashley, that would be $10,000 (10% of her $100,000 AGI) so her penalty-free IRA withdrawals would be reduced to $2,000. Effective date: 2013.

- **Flex plans.** Many employers offer cafeteria plans, also known as flexible spending arrangements (FSAs). These plans allow employees to pay certain expenses, including health care costs, with pretax dollars. At many companies, employees can contribute up to $5,000 of compensation to health care FSAs. The new laws will limit annual health care FSA contributions to $2,500. Effective date: 2013. ■

TAX CALENDAR

JULY 2010

July 15

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in June if the monthly rule applies.

AUGUST 2010

August 2

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the second quarter of 2010. Deposit any undeposited tax. (If your tax liability is less than $2,500, you can pay it in full with a timely filed return.) If you deposited the tax for the quarter in full and on time, you have until August 10 to file the return.

For federal unemployment tax, deposit the tax owed through June if more than $500.

If you maintain an employee benefit plan with a calendar year end, file Form 5500 or 5500-EZ for calendar year 2009.

August 10

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the second quarter of 2010. This due date applies only if you deposited the tax for the quarter in full and on time.

August 16

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in July if the monthly rule applies.

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