

Tax Tidbits

Dealing with Health Care Reform's New Tax Laws

Now that Congress has passed a landmark health care reform package, much work needs to be done in dealing with new requirements. While the end result of the legislative process is health care related, the tax law plays a major role in its implementation. From the tax credits and subsidies used to expand health coverage, to the many penalties, fees and surtaxes designed to pay for it, the Tax Code is front and center.

Two new laws

Health care reform is actually made up of two new laws: the Patient Protection and Affordable Care Act (PPACA) of 2010 and the Health Care and Education Reconciliation Act (The Reconciliation Act) of 2010. The PPACA was crafted largely in the Senate and sets out the general framework of health care reform. The Reconciliation Act was prepared in the House to modify the PPACA, especially in the areas of tax credits and cost sharing for individuals to help make coverage more affordable. Common features to both laws are delayed effective dates for many of the provisions, which make strategic planning all that more important.

New taxes and penalties

Viewing the historic health care reform package from the context of the Tax Code, many new taxes and penalties stand out immediately. Initially, we would advise taking particular note of the following highlights:

- Individuals who earn more than \$200,000 for the year (\$250,000 for married couples) will be paying an additional 0.9 percent in Hospital Insurance (Medicare) tax, starting in 2013.
- Individuals whose adjusted gross income for the year exceed \$200,000 (\$250,000 for joint filers), whether from wages or otherwise, will also be paying an additional 3.8 percent Medicare tax on net investment income, starting in 2013.
- Employers with 50 or more employees generally will be required to provide a minimum level of health insurance for their employees or pay a penalty per employee, starting in 2014.
- Small employers with no more than 25 employees are entitled to up to a 35 percent tax credit on the cost of providing health insurance for employees, starting immediately in 2010.
- Most individuals will be required to obtain health insurance or be subject to a penalty tax, starting in 2014.
- Tax credits to subsidize the cost of health insurance premiums will be available to individuals earning up to 400 percent of the poverty level, starting in 2014.
- Health flexible savings arrangement (FSA) dollars will be limited to prescription medications with some exceptions after 2010, along with placing a \$2,500 annual cap on expenses covered under health FSAs, starting in 2013.

Volume 11, Issue 2
May 2010



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- A 40 percent excise tax will be imposed on high-cost, “Cadillac” employer sponsored health coverage, starting in 2018.
- Fees will be imposed on the pharmaceutical industry and health insurance providers, starting in 2011 and 2014, respectively.
- An excise tax will be imposed on medical device manufacturers after 2012.
- Limits on tax-subsidized medical expenses will be imposed by raising the itemized medical expense deduction floor for regular tax purposes from 7.5 percent to 10 percent, starting in 2013.

Tax incentives

Among a handful of tax incentives provided under the new health-care reform package, two are particularly notable at this time: (1) the ability of parents to cover adult children up to age 27 under their tax-qualified employer-provided health plans, starting immediately on or after March 23, 2010; and (2) the unveiling of a simplified cafeteria plan specifically tailored to small businesses, starting in 2011.

IRS guidance

Over the course of the next few months, the IRS and other federal agencies will be filling in details on how to comply with all the provisions under the massive health care reform package. The IRS is expected to issue guidance soon on the provisions with effective dates in 2010 and 2011. We will be staying on

top of all developments with an eye toward how to best maximize results for our clients under the new laws. We are prepared to advise our clients on all compliance rules and tax-reduction opportunities that undoubtedly will arise. In the meantime, if you have any questions about the new laws, please call our office.

~ Paul E. Hornbuckle, CPA
Tax and Business Services
Manager

Alternative Revenue Generation

In this recessionary economy, state and local governments must find alternative ways to generate revenues to fund their operations. This is due to a number of factors, such as lower wage earnings due to unemployment and its negative effects on the related income taxes. This situation also fails to generate sales tax revenue due to lower spending by individuals and businesses since they do not have the money to spend or they are bearish on the economy as a whole. The other reaction to a downturned economy involving businesses is where income and its related taxes are not reported. This is being dealt with swiftly by New York State, as well as other states. The number of audits is up as well as tax yields from those audits. New York, for example, has actually hired more sales tax auditors. There are two types of sales taxes, the ones

collected at the point of sale, which are collected and later remitted, and the second type which is legally what is referred to as a use tax. Use tax is a tax due upon the purchase of goods or services that is taxable; however, the vendor does not charge the tax. New York is aggressively going after the collection of these two types of taxes. In a downturned economy, some businesses use the sales taxes collected and, when it comes time to remit to the state, they have already spent the money. Business owners are going to jail over such business practices.

Another area where revenues should be up is in traffic enforcement. In Chemung County, New York, speeding tickets are up by 18.5% from the prior year. This is definitely going to be a trend in all localities as revenues from the states dry up. *So, watch your speed!*



Code Sec. 179 Expense Election for 2010

The 2010 HIRE Act has extended for one additional year the increased Code Sec. 179 expense allowance that was provided for tax years beginning in 2008 and 2009. Under IRC Section 179, individuals,

partnerships, and corporations may elect to deduct as an expense the cost of qualifying property in the year the property is placed in service. The amount claimed as a Section 179 expense reduces the basis of the asset for purposes of computing regular depreciation. As a result, the Code Sec. 179 dollar limitation is \$250,000, and the investment limitation is \$800,000. An expense deduction is provided for taxpayers (other than estates, trusts or certain non-corporate lessors) who elect to treat the cost of qualifying property, called Section 179 property, as an expense rather than a capital expenditure. Section 179 property is depreciable tangible property that is purchased for use in the active conduct of a trade or business. Without further legislation, the dollar and investment limitations for tax years beginning in 2011 will be \$25,000 and \$200,000, respectively.

Payroll Tax Holiday

A qualified employer is provided an exemption from having to pay the employer share of old-age, survivors and disability insurance (OASDI) taxes for qualified individuals' employment from the day after March 18, 2010 through December 31, 2010. The employer can claim a credit of up to \$1,000 for retaining a newly hired worker for at least 52 consecutive weeks. The qualified individual being hired must begin employment with a qualified employer

after February 3, 2010, and before January 1, 2011. The individual certifies, by signed affidavit under penalty of perjury, that he/she has not been employed for more than 40 hours during the 60-day period ending on the date that employment begins, is not hired to replace another employee of the qualified employer, with exceptions, and is not related to the employer. The payroll tax holiday will not affect the worker's future social security, because additional appropriations were made to replace the lost OASDI taxes, as directed by the 2010 HIRE Act.

Medicare Contribution Tax on Unearned Income

Effective for tax years beginning after December 31, 2012, a 3.8 percent Medicare tax is imposed on the lesser of an individual's net investment income for the tax year or modified AGI in excess of \$200,000 (\$250,000 in the case of joint filers and surviving spouses, and \$125,000 in the case of a married taxpayer filing separately).

Medicare tax is meant to finance hospital and hospital service insurance for those 65 years of age or older. To the point of the effective date of this portion of the law, Medicare tax has only been imposed on wages and net earnings from self-employment, not on investment income. Net investment income, as it applies to this tax, is the excess of the sum of the

following items over any allowable deductions allocable to such income or gain:

1. Gross income from interest, dividends, annuities, royalties and rents, unless such income is derived in the ordinary course of any trade or business, for example portfolio income or gas royalties.
2. Other gross income from any passive trade or business, such as rental activities or gas lease income.
3. Net gain included in computing taxable income that is due to the disposition of property other than property held in any trade or business that is not a passive trade or business. Gross income in this tax law provision does not include tax-exempt interest, veteran's benefits, a gain ordinarily excluded on the sale of a principal residence under IRC Sec 121, or distributions from qualified retirement plans as covered by IRC Sec. 401(a), 403(a) or (b), 408, 408A or 457(b).

Additionally, income from a trade or business conducted by a sole proprietor, partnership, or S corporation is not includable in the calculation of investment income, unless it is passive in nature. Passive activities are defined as those businesses where the investor has not actively managed or been involved with the "day-to-day" activities of the company or organization.

Itemized Deduction for Medical Expenses

For years commencing after December 31, 2012, the threshold to claim an itemized deduction for unreimbursed medical expenses is increased from 7.5 percent of adjusted gross income (AGI) to 10 percent of AGI for regular income tax purposes. Much to the dismay of some tax clients, out of pocket expenses for medical costs are deductible, subject to certain limitations. Expenses paid for medical care include amounts paid for diagnosis, cure, mitigation, treatment or prevention of disease and for treatments affecting any part or function of the body. Only payments for legal medical services rendered by physicians, surgeons, dentists, and other medical practitioners qualify as medical expenses. Expenses that are simply beneficial to general health, such as vitamins, food or vacations, are not deductible.

Here's the kicker, under current tax law, the allowed medical deduction is only allowed for regular taxes to the extent that expenses exceed 7.5% of AGI, however, for alternative minimum tax (AMT) purposes, medical expenses are deductible only to the extent that they exceed 10 percent of AGI. In conclusion, what the new law is doing, is "backdoor"

everybody into the equivalent of AMT treatment of medical expenses.



Limitation of Distributions from Health Accounts

Directly out of the Patient Protection and Affordable Care Act (PPACA) comes a very contradictory provision. In this new provision, the cost of over-the-counter medicines may not be reimbursed with excludable income, such as from health savings accounts (HSA), health reimbursement arrangement (HRA) and health flexible spending arrangements (FSA), unless the medicine is prescribed by a physician. It should be noted that the IRS ruled in 2003 that Health FSA's could be drafted to allow for the reimbursement of certain over-the-counter medicines. The change at the time allowed FSA's to reimburse over-the-counter medicines presented a cheaper alternative for those relying upon medicines to treat chronic conditions. This meant that the employee had a tax savings means to purchase the necessary

medicines without a costly visit to the doctor's office. This law change, which becomes effective for tax years beginning after December 31, 2010, restricts coverage once again to prescribed medicines. The cheaper option no longer exists. To add "insult to injury", under another provision of the PPACA, the additional tax on distributions from HSAs or Archer medical savings accounts (MSAs) not used for qualified medical expenses is increased to 20 percent of the amount of the distribution included in gross income. Under current law, the additional tax is 10 percent. In conclusion, if you error, it will cost you income tax at your effective tax rate, plus 20% of the includable amount.

Our location at 350 West Church Street has become familiar to our clients. With adequate parking in the back, it is a convenient location to meet with one of our tax specialists to discuss tax questions and solutions.

Please call our office at (607) 733-9022 in order to set up appointments.



Located at the northwest corner of West Church and Columbia Street

This document was not intended or written to be used, and it cannot be used, for the purpose of avoiding tax penalties that may be imposed on the taxpayer.

"Make money and the whole world will conspire to call you a gentleman" – *Mark Twain*