HEALTH CARE ACT TAX OVERVIEW

INDIVIDUALS

Expanded Medicare taxes and other changes for 2013 and beyond make planning critical

GTM payroll services

518.373.4111 • GTM.com

The Patient Protection and Affordable Care Act of 2010 includes some significant tax-related provisions affecting individuals, many of which go into effect in 2013. With the U.S. Supreme Court upholding most provisions and President Obama being re-elected, it appears the act's tax provisions will go into effect as scheduled. These provisions, combined with other tax increases, make tax planning especially critical this year.

Here's a closer look at key tax provisions and proposed IRS guidance (which can be relied on for filing purposes). Additional rules apply, so consult your tax advisor to determine exactly how you'll be affected.

Medicare tax increase on earned income

Under the Federal Insurance Contributions Act (FICA), wages are subject to a 2.9% Medicare tax — 1.45% paid by the employers and 1.45% withheld from the employees' wages. (The self-employed pay both portions, but they can deduct the employer portion for income tax purposes.) Under the health care act, starting in 2013, taxpayers with earned income over $200,000 per year ($250,000 for joint filers and $125,000 for married filing separately) must pay an additional 0.9% in Medicare taxes on the excess earnings.

Withholding issues

Unlike regular Medicare taxes, the 0.9% additional Medicare tax *doesn't* include a corresponding employer portion. But employers *are* obligated to withhold the additional tax beginning in the pay period in which wages exceed $200,000 for the calendar year — without regard to the employee's filing status or his or her income from other sources.

So your employer could be required to withhold the tax from your wages even if you aren't liable for it — because, for example, your and your spouse's wages together don't exceed the $250,000 threshold for joint filers. You can't ask your employer to stop withholding the tax, but you can claim a credit for it on your income tax return for the year.

It's also possible that the additional tax won't be withheld from your wages even though you *are* liable for it. This could occur if you and your spouse file jointly and neither of you earns more than $200,000 but together your wages exceed $250,000. Similarly, no additional tax will be withheld if you have two jobs and neither job pays wages in excess of the threshold. If you're in such a situation, you may use Form W-4 to request additional income tax withholding to cover your liability for the additional tax. To the extent the additional liability isn't covered by withholding, use estimated tax payments to make up the shortfall and avoid interest and penalties.

If your employer under- or overwithholds additional Medicare tax compared to *its* obligations (not compared to your actual liability), it can collect underpaid amounts from your wages or reimburse overpaid amounts to you before the end of the year.

Minimizing the additional tax

You might be able to implement strategies that will help you reduce or avoid the 0.9% additional Medicare tax. Some of these strategies also may help reduce or defer income taxes, which may be especially valuable given that the top income tax rate also has gone up for higher-income taxpayers.

But, complicating matters is the fact that the two tax increases kick in at different levels — and based on different definitions of income. (See Chart 1 on page 2.) You may owe the additional 0.9% Medicare tax even if your marginal income tax rate doesn't go up.

Here are some strategies to consider:

Time income. If your wages or self-employment income varies significantly from year to year or you're close to the threshold for triggering the additional Medicare tax, income timing strategies may allow you to avoid or minimize the additional tax. For example, if you're an employee, perhaps you can time when you receive a bonus, or you can defer or accelerate the exercise of stock options. If you're self-employed, you may have flexibility on when you purchase new equipment or invoice customers.

Revisit S corporation salary vs. distributions. If you're a shareholder-employee of an S corporation, you might save tax by adjusting how much you receive as salary vs. distributions. There is more to this decision than simply the salary/distribution split, however; consult with your tax advisor for analysis of your particular situation.

New Medicare tax on investment income

Perhaps the most significant tax provision of the health care act is the new 3.8% tax on *unearned* income of higher-income taxpayers. Beginning in 2013, the net investment income tax (NIIT, also known as the Medicare contribution tax) will be applied to net investment income to the extent modified adjusted gross income (MAGI) exceeds the same threshold amounts that apply to the 0.9% tax on earned income. (See Chart 1.)

Income subject to the NIIT

For NIIT purposes, investment income may include (but isn't limited to):

- Interest,
- Dividends,
- Capital gains, and
- Rental and royalty income.

Investment income may also include income from nonqualified annuities (including payments under life insurance contracts), businesses involved in the trading of financial instruments or commodities, and businesses that are passive activities to you (meaning you don't "materially participate" in the business).

Net investment income is calculated by deducting from investment income certain expenses that can be allocated to that income. Deductible expenses include interest expense, advisory and brokerage fees, expenses related to rental and royalty income, and state and local income taxes. Deductions aren't allowed for net operating losses.

You're required to report and pay the NIIT on your income tax return. If you meet the applicable MAGI threshold and have net investment income, the NIIT equals 3.8% of the lesser of the amount by which your MAGI exceeds the threshold or your net investment income. In other words, all of your net investment income may not be subject to the NIIT.

Income exclusions

Income from interest, dividends, annuities, rents and royalties is excluded from investment income if the income is derived in the ordinary course of a trade or business that's not a passive activity with respect to you or trading in financial instruments or commodities. Investment income also doesn't include operating income from an active (that is, nonpassive) business or interest on tax-exempt bonds.

Income distributions from these retirement or similar plans are also excluded:

- Qualified pension, stock bonus or profit-sharing plans,
- Qualified annuity plans,
- Tax-sheltered annuities,
- Traditional IRAs,
- Roth IRAs, and
- Deferred compensation plans of a state and local government or a tax-exempt organization.

Distributions from these plans are, however, taken into account when determining your MAGI — so they could trigger NIIT on net investment income.

Notably, the NIIT also doesn't apply to any amount of gain that's excluded from gross income for regular income tax purposes. This means the first $250,000 ($500,000 for a married couple filing jointly) of gain recognized on the sale of a principal residence is excluded from the NIIT, provided you meet the requirements for the exclusion.

Minimizing NIIT

Several strategies are available to reduce the impact of the NIIT, and they also

CHART 1 2013 Medicare and income tax increases triggered based on varying factors

			Income threshold by type of filer		
Type of tax increase	**Type of income taxed**	**Type of income threshold**	**Single**	**Head of household**	**Married filing jointly**
0.9% additional Medicare tax	FICA wages and self-employment income	FICA wages and self-employment income	$200,000	$200,000	$250,000
39.6% marginal income tax rate	Taxable income other than long-term capital gains and qualified dividends	Taxable income	$400,000	$425,000	$450,000
3.8% NIIT / Medicare contribution tax	Net investment income	Modified adjusted gross income	$200,000	$200,000	$250,000
20% long-term capital gains rate	Long-term capital gains[1] and qualified dividends	Taxable income	$400,000	$425,000	$450,000

[1] *Different rates apply to certain types of gains.*

may help you avoid triggering the higher capital gains tax rate that goes into effect this year (see Chart 1):

Time gains and losses. Smart timing of gains and losses may allow you to avoid hitting the NIIT threshold or at least defer NIIT liability. Appreciation on investments isn't included in net investment income until the investment is sold and capital gains are recognized. So holding on to such investments may allow you to time the sale to your tax advantage — such as in a year when you have capital losses to absorb the capital gain. Or, if you've cashed in some big gains during the year, before year end look for unrealized losses in your portfolio and consider selling them to offset your gains.

Consider installment sales. If you're selling highly appreciated assets this year, you may want to consider installment arrangements, because they'll defer the gain out over several years and might allow you to stay under the threshold that would trigger the NIIT. Be aware, however, that not all asset sales are eligible for installment treatment.

Gift highly appreciated assets to family members. If you have family members who won't be subject to the NIIT because their incomes are too low, consider transferring highly appreciated assets to them. They can sell the assets and your family as a whole will save NIIT.

This strategy may be even more advantageous if the family member is subject to a lower long-term capital gains rate than you are. Remember, depending on your income, you may be subject to a 20% rate. Although a 15% rate still applies to most tax brackets, the 0% long-term capital gains rate applies to those in the 10% and 15% brackets.

If the family member will be under age 24 on Dec. 31, first make sure he or she won't be subject to the "kiddie tax." Regardless of the recipient's age, consider any gift tax consequences.

Execute Roth IRA conversions. Converting traditional IRAs and 401(k) accounts to Roth accounts will remove

CASE STUDY

Impact of expanded Medicare tax can vary significantly

The impact of the expanded Medicare tax can vary significantly depending on the mix of income from wages vs. investments and whether a taxpayer is single or married. The filers in all of these scenarios have $400,000 of income.

Scenario 1. Matthew, who's single, earns $400,000 in wages in 2013 and has no other income. He would be taxed as follows: 1.45% × $400,000 + 0.9% × $200,000 ($400,000 - $200,000 threshold) = $5,800 + $1,800 = $7,600. His Medicare cost on the same earnings in 2012 would, by comparison, have been just $5,800.

Scenario 2. John and Heather are married and file jointly. John earns $150,000 in wages and Heather is subject to self-employment tax on $250,000, and they have no investment income. John's wages don't exceed the $250,000 threshold for joint filers, so the couple isn't liable for additional Medicare tax on his wages. To calculate the tax they'll pay on Heather's self-employment income, John's $150,000 is subtracted from the $250,000 threshold, for a reduced threshold of $100,000. The couple is liable for additional Medicare tax on $150,000 ($250,000 - $100,000), for an additional tax of $1,350. The couple's total Medicare tax is $10,775 (1.45% × $150,000 + 2.9% × $250,000 + $1,350). But Heather can deduct the $3,625 "employer" portion of Medicare tax for income tax purposes.

Scenario 3. Jane's modified adjusted gross income (MAGI) in 2013 is $400,000, consisting of $200,000 in wages and $200,000 in net investment income. Jane is single. Her share of Medicare tax on her wages would be 1.45% × $200,000, or $2,900 — she's not subject to the additional 0.9% tax, because her wages don't exceed the $200,000 threshold. Her net investment income, however, is subject to the net investment income tax (NIIT). The additional tax would be 3.8% × $200,000, or $7,600 — for a total Medicare tax of $10,500.

Scenario 4. Like Jane, Andy is single and his 2013 MAGI is $400,000 — but it consists of $100,000 in wages and $300,000 in net investment income. Like Jane, he owes no additional Medicare tax on his wages because they don't exceed the $200,000 threshold. And, even though he has $100,000 more in net investment income, he also owes the same $7,600 amount of NIIT. Why? Because only the amount of net investment income after he hits the $200,000 MAGI threshold is subject to the NIIT. But because his wages are $100,000 less, his total Medicare tax is less than Jane's — only $9,050 ($100,000 × 1.45% + $7,600).

Scenario 5. Eric and Anita each have a MAGI of $200,000 in 2013, consisting of $170,000 in wages and $30,000 in net investment income. Neither exceeds the $200,000 threshold, so if they were single, neither would be subject to the 0.9% or 3.8% tax; they'd each owe $2,465 in Medicare taxes (1.45% × $170,000). However, Eric and Anita are married. Their combined wages of $340,000 exceed the $250,000 threshold, resulting in an $810 tax (0.9% × $90,000). And because their $400,000 in MAGI exceeds the threshold, their investment income will be subject to a $2,280 NIIT (3.8% × $60,000). In other words, they'll pay a marriage "penalty" of an additional $3,090 in Medicare taxes, for total Medicare taxes of $8,020.

future distributions from MAGI and thus may reduce future exposure to the NIIT. But converted amounts generally are taxable in the year of conversion — and thus will be included in MAGI and could trigger NIIT in the conversion year. You may be able to make a partial conversion and avoid triggering NIIT.

Whether a conversion makes sense for you depends not only on whether a conversion or future distributions could trigger the NIIT but also on factors such as your age, whether you can afford to pay the tax on the conversion, your tax bracket now and expected tax bracket in retirement, and whether you'll need the IRA funds in retirement. It's also important to consider rules about penalties associated with future withdrawals of the converted funds.

Increase retirement plan contributions. To the extent you can make pretax or deductible contributions to retirement plans, you can reduce your MAGI and, potentially, reduce or eliminate the NIIT. So if you're not currently contributing up to the applicable annual limits, consider increasing your contributions.

Other changes

While expanded Medicare taxes may have the biggest impact on your tax liability, other changes under the health care act also could affect your taxes in 2013 and beyond. Here's a closer look at some of the most significant.

Increased threshold for medical expense deduction

Beginning in 2013, the health care act raises the threshold for the itemized deduction for unreimbursed medical expenses from 7.5% of adjusted gross income to 10%. (The 10% threshold already applied for alternative minimum tax purposes.) The increase is waived for individuals age 65 or older for tax years 2013 through 2016.

To help qualify for the deduction, think about "bunching" nonurgent medical expenses in alternating years. Controllable expenses might include prescription drugs, eyeglasses and contact lenses, hearing aids, dental work, and elective surgery.

New FSA limit

The new year ushered in a new limit on pretax employee contributions to Flexible Spending Accounts (FSAs) for health care. Previously, employers could set whatever limit they wanted. Starting in 2013, they can't set a limit exceeding $2,500. (The $2,500 amount will be annually adjusted for inflation.)

If you're concerned about a lower FSA limit and aren't currently contributing to a Health Savings Account (HSA), look into whether you're eligible. To contribute, you must be covered by a qualified high-deductible health plan (HDHP). See Chart 2 for information on HSA limits.

CHART 2 2013 FSA, HSA and HDHP limits

	Individual	Family
FSA annual contribution limit	$2,500[1]	$ 2,500[1]
HSA annual contribution limit	$3,250	$ 6,450
HSA catch-up[2] contribution limit	$1,000	$ 1,000
Minimum HDHP deductible	$1,250	$ 2,500
Maximum HDHP out-of-pocket costs	$6,250	$12,500

[1] Employer can set lower limit.
[2] Individuals age 55 and older may qualify to make these additional contributions.

As with FSA withdrawals, HSA withdrawals for qualified medical expenses are tax-free. But HSAs may be more beneficial because they can bear interest or be invested and can grow tax-deferred similar to an IRA. Plus, you can carry over a balance from year to year. If you have an HSA, however, your FSA is limited to funding certain "permitted" expenses.

Another HSA benefit is that it can provide a way to do some "after-the-fact" Medicare tax planning: You have until the April filing deadline to make your contribution. So, if for a particular year you happen to be on the cusp of having to pay the NIIT, an HSA contribution may allow you to get your MAGI below the threshold and, consequently, save some tax.

Individual mandate

Although you likely have health insurance, the individual mandate warrants a brief discussion because it was the centerpiece of the Supreme Court case and relates to taxes. The mandate requires almost all Americans to purchase health insurance by 2014 or pay a penalty — which Chief Justice Roberts characterized as a tax.

Individuals who aren't insured will need to weigh the penalty against the cost of obtaining health coverage. The penalty will be phased in over three years, reaching a maximum of 2.5% of family income in 2016. If you have adult children who're no longer covered on your policy but don't yet have coverage themselves, make sure they're aware of the penalty they could face.