



# Client Bulletin

Smart Tax, Business & Planning Ideas *from your Trusted Business Advisor*<sup>SM</sup>

## The Supreme Court's Health Insurance Decision: What It Means to You Now

October 2012

The Supreme Court has let stand most of the provisions of two federal laws passed in 2010 by holding the requirement that most Americans purchase health insurance constitutional. Those laws, the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act, contain multiple provisions, some of which already have gone into effect.

The most contentious provision of those laws—the requirement that most Americans purchase health insurance—won't take effect until 2014.



That provision is extremely complicated with both penalties for noncompliance and subsidies for people at certain income levels. The IRS has promised more guidance in this area. Expect more information to come in future issues of the *CPA Client Bulletin* as the time for compliance draws near, and the federal government fills in the details.

That said, some provisions of these major laws will go into effect in 2013, as scheduled. If you know what will change next year, you may be able to adjust your plans accordingly. ■

## New Tax for High-Income Taxpayers

Starting in 2013, certain taxpayers will owe an additional 3.8% "Medicare" tax. (The money raised will be allocated to the Medicare program.) To be affected, you must have both an ample gross income and income from investments.

► **Gross income.** This 3.8% surtax applies to taxpayers filing joint returns or surviving spouses with modified adjusted gross income (MAGI) over \$250,000, married individuals filing separate returns with MAGI over

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\$125,000, and all other individuals with MAGI over \$200,000. MAGI, for this purpose, is your regular AGI plus any foreign earned income you've excluded. "MAGI and AGI will almost always be the same," says Bob Keebler of Keebler & Associates, a tax advisory and CPA firm in Green Bay, Wisconsin. "MAGI does not include tax-exempt income, excluded gain on the sale of a principal residence, or veteran's benefits."

▶ **Investment income.** This includes taxable interest, dividends, capital gains, annuities, royalties, and real estate rentals. The tax is on net investment income, so you'll subtract expenses such as investment interest you've paid.

### Crunching the numbers

The tax will be owed on the lesser of two numbers. One is your net investment income; the other is the amount by which your MAGI exceeds the relevant \$125,000, \$200,000, or \$250,000 threshold.

**Example 1:** Phil Roberts, a single taxpayer, has MAGI of \$300,000 in

2013 but no countable investment income because he invests solely in tax-exempt bonds. With net investment income of zero, Phil will not owe the 3.8% surtax, no matter how high his AGI or MAGI might be.

**Example 2:** Suppose that Phil has the same \$300,000 of MAGI in 2013, but it includes \$75,000 of net investment income. Now, Phil's net investment income (\$75,000) is less than the \$100,000 excess over his \$200,000 MAGI threshold. The 3.8% is imposed on the smaller amount, so Phil will owe 3.8% of \$75,000 in surtax: \$2,850.

**Example 3:** Now suppose Phil Roberts' \$300,000 of MAGI in 2013 includes \$125,000 of net investment income. Phil is still \$100,000 over the MAGI threshold, but that overage is less than his \$125,000 of net investment income, so he will owe a \$3,800 surtax: 3.8% of \$100,000.



### First call

You cannot reduce the 3.8% surtax by taking large itemized deductions, such as charitable contributions and mortgage interest. This surtax is based on your AGI, which you report on the bottom of page 1 of your income tax return. Anything that swells your AGI—including capital gains and retirement plan distributions—increases the likelihood that you'll be over the MAGI threshold for your tax filing status and, thus, owe the surtax.

The November 2012 *CPA Client Bulletin* will be devoted to year-end tax tips, including ways to minimize the 3.8% surtax in the future. ■

## Trusts and Estates May Owe the Surtax, Too

The 3.8% Medicare surtax described in the article, "New Tax for High-Income Taxpayers," is not limited to individual taxpayers. Trusts and estates also may owe the tax. For trusts and estates, the calculation is slightly different than it is for individuals.

Starting in 2013, trusts and estates will owe the 3.8% surtax on the lesser of (a) undistributed net investment income or (b) the excess of adjusted gross income (AGI) over the threshold for the highest estate and trust income tax bracket. In 2012,

trusts and estates owe the highest tax rate (35%) on taxable income over \$11,650. After adjusting for inflation, it's likely that figure for 2013 will be around \$12,000.

**Example:** Wendy Miller died a few years ago and left \$1 million in trust for her two children. In 2013, the trust earns \$60,000 of net investment income, of which \$40,000 is distributed to the beneficiaries. Thus, the trust has \$20,000 of undistributed net investment income.

If the top trust tax rate applies to taxable income over \$12,000

next year, and the trust's adjusted gross taxable income is \$20,000, it is \$8,000 over the threshold. The 3.8% surtax applies to the smaller amount—\$8,000 instead of \$20,000—in this example.

Executors and trustees may want to reduce investment income in order to reduce exposure to steep income tax rates and the 3.8% surtax. Tax-efficient tactics might include investing in municipal bonds and low-dividend growth stocks, as long as such holdings fit with overall investment plans. ■

# Additional Medicare Tax for Certain High-Income Taxpayers

Under current law, all workers pay 1.45% of their wages to the Medicare hospital insurance program. Employers pay a matching 1.45%; self-employed individuals pay both sides, for a total of 2.9%. This tax generally applies to all wages and self-employment income with no cap.

Starting in 2013, some taxpayers will owe an additional 0.9% on wages from employment or self-employment income. The tax applies to taxpayers filing joint returns with combined wages or self-employment income over \$250,000 (married taxpayers filing separately with wages or self-employment income over \$125,000). For all other taxpayers, the threshold is \$200,000. For self-employed taxpayers, the threshold amounts are reduced by the amount of wages taken into account in determining the FICA tax of the taxpayer(s). However, only the excess of the wages or self-employment income that is over the threshold is subject to the additional tax.

**Example 1:** John Mason, a single taxpayer, works for ABC Corp. with a salary of \$220,000 per year. On the first \$200,000 of that income, John will pay Medicare tax of 1.45%, and ABC will also pay 1.45% in Medicare tax on John's behalf. On the last \$20,000, ABC will continue its 1.45% employer payment, but John's Medicare tax rate will increase from 1.45% to 2.35%. In this example, John pays an extra \$180 in tax due to the tax increase: 0.9% of the excess \$20,000.

If John is self-employed, the same principle applies. Starting in 2013, assuming that he earned no wages subject to FICA during the year, he will have to withhold a total of 2.9%

of all earnings up to \$200,000 and 3.8% (2.9% plus the additional 0.9%) on all earnings above that. Although self-employed taxpayers are allowed an above-the-line deduction for the employer's share of the Medicare tax, the additional 0.9% Medicare tax is considered the employee's share, so it is not deductible on John's income tax return.

Note that this 0.9% surtax is on earned income, not on gross income or taxable income.

## Spousal situations

As mentioned previously, this tax is applied to the joint wages from employment or self-employment income of married couples filing joint returns over \$250,000 per year. However, employers usually have no way of knowing the wages or self-employment income of an employee's spouse, so companies generally will start the extra withholding on an employee's wages over \$200,000 per calendar year, which is the threshold for a single taxpayer. Therefore, for a couple where both spouses are employees, withholding typically will be based on each individual spouse's wages. This might lead to improper withholding.

**Example 2:** Victor Morgan is employed by XYZ Corp. In 2013, Victor's salary is \$190,000, so XYZ does not withhold the 0.9% surtax from any of Victor's paychecks. However, Victor's wife, Kim, also has \$190,000 of wages in 2013, and her employer also does not withhold the surtax. Thus, the couple's \$380,000 of combined wages is over the \$250,000 threshold by \$130,000. They will owe \$1,170: 0.9% of \$130,000.

Working couples in such situations may have to make estimated tax payments. Otherwise, they could owe underpayment penalties when they file their tax return for the year at issue due to the withholding shortfall. Other couples will be in the opposite situation, having had more tax withheld than necessary.

**Example 3:** Gloria Allen earns \$240,000 from her job in 2013, so her employer withholds an extra 0.9% on \$40,000 of her income. However, Gloria's husband is retired with no earned income, so the couple has a total of \$240,000 of combined wages from employment for that year. The Allens do not owe the 0.9% extra Medicare tax, so they will have \$360 of surplus withholding (0.9% of \$40,000). ■

## Did You Know?

**F**ederal health insurance legislation passed in 2010 allowed parents to keep children up to age 26 on their health insurance. According to the Department of Health and Human Services, 3.1 million young adults were able to access health insurance because of the law. The proportion of insured adults age 19-25 climbed to nearly 75% as a result.

Source: Reuters.com

# Higher Hurdles for Medical Deductions and Exemptions

Taxpayers who itemize deductions on Schedule A of Form 1040 can claim excess medical expenses. Under current law, you can deduct unreimbursed expenses for medical care that exceed 7.5% of adjusted gross income (AGI). Starting in 2013, the floor rises to 10% of AGI.

**Example 1:** Abby Young has \$100,000 of AGI in 2012 and \$11,000 of deductible unreimbursed medical expenses. Her threshold for deductions is \$7,500: 7.5% of \$100,000. Thus, Abby can deduct the excess \$3,500 (\$11,000 minus \$7,500) on Schedule A of her 2012 tax return.

Assume that Abby has exactly the same experience in 2013—\$100,000 of AGI and \$11,000 in deductible unreimbursed medical expenses. Next year, her deduction threshold will be \$10,000 (10% of \$100,000), so her deduction will be reduced to \$1,000 in 2013.

Taxpayers 65 and older get a temporary reprieve from this potential tax hike. For them, the 10% threshold won't take effect until 2017. For married couples filing joint returns, this four year tax break is in effect if either spouse is at least 65 years old before the end of the tax year for tax years before 2017.

## Affecting early withdrawals

The change in the AGI threshold for medical expense deductions may also affect early withdrawals from IRAs and other retirement plans. Typically, taxpayers owe a 10% penalty on withdrawals before age 59½, in addition to regular income tax. The penalty is waived for withdrawals to the extent the withdrawals do not exceed the amount allowable as a deduction for medical care expenses for the tax year.

**Example 2:** Liz Oldman, age 54, has \$100,000 of AGI and \$11,000

of deductible unreimbursed medical expenses in 2012. Her 7.5% of AGI threshold is \$7,500, and her excess medical bills are \$3,500. In this scenario, Liz can withdraw up to \$3,500 from her IRA this year; she'll owe income tax but not the 10% penalty.

Assume that Liz has exactly the same experience in 2013—a \$100,000 AGI and \$11,000 in unreimbursed medical expenses. Next year, her threshold for penalty-free IRA withdrawals will be \$10,000, so Liz can withdraw no more than \$1,000 from her IRA in 2013 before she owes the 10% penalty. Liz can take these penalty-free distributions (\$3,500 in 2012 and \$1,000 in 2013) regardless of whether she itemizes deductions on Schedule A of her tax return. ■

## TAX CALENDAR

### OCTOBER 2012

#### October 15

**Individuals.** If you have an automatic six-month extension to file your income tax return for 2011, file Form 1040, 1040A, or 1040EZ and pay any tax, interest, or penalties due.

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

**Electing large partnerships.** If you were given an additional six-month extension, file a 2011 calendar year tax (Form 1065-B).

#### October 31

**Employers.** For Social Security, Medicare, and withheld income tax, file Form 941 for the third quarter of 2012. 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 November 13 to file the return.

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

### NOVEMBER 2012

#### November 13

**Employers.** For Social Security, Medicare, and withheld income tax, file Form 941 for the third quarter of 2012. This due date applies only if you deposited the tax for the quarter in full and on time.

#### November 15

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