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Tax implications for 2013 and beyond require planning and preparation now

The U.S. Supreme Court ruling earlier this year has drawn attention to the Patient Protection and Affordable Care Act of 2010. The act includes some significant tax-related provisions affecting individuals that are scheduled to take effect in 2013 and 2014, unless Congress repeals them or takes other action. In addition, businesses face a variety of tax-related compliance requirements under the act, though certain small businesses may be eligible for a tax-saving opportunity. What both individuals and businesses need to do now is plan and prepare.

Individuals

The health care act's tax provisions combined with other scheduled tax increases mean that many taxpayers should consider taking certain steps before year end to help minimize the impact.

Medicare tax increases

The health care act will increase Medicare taxes for many higher-income taxpayers. 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 extra 0.9% (from 1.45% to 2.35%) in Medicare taxes on the excess earnings.

Perhaps more significantly, the health care act also imposes a new 3.8% tax on *unearned* income — such as interest, dividends, rents, royalties and certain capital gains — of higher-income taxpayers. The tax will be applied to net investment income to the extent modified adjusted gross income (MAGI) exceeds the same threshold amounts that apply to earned income. (See Case Study I on page 2.)

Affected taxpayers don't have much recourse when it comes to the extra tax on *earned* income, but, depending on your situation, you might have some limited tax-saving opportunities:

- If you expect to receive a bonus at the beginning of 2013, you may want to see if it could be paid out by Dec. 31, 2012, instead, so you can avoid the additional Medicare tax. However, you'll first want to check whether the bonus would push you into a higher income tax bracket this year.
- If you're a shareholder-employee of an S corporation, you may want to revisit 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.

Several strategies are available to reduce the impact on *unearned* income. The benefit of these strategies may be even greater if the long-term capital gains and ordinary-income tax rates increase in 2013 as scheduled:

Time gains and losses. It might be worthwhile to realize long-term capital gains in 2012, depending on your financial goals and other considerations. This will allow you to avoid the additional Medicare tax as well as lock in the 15% long-term capital gains rate while it's available. Conversely, you may want to defer capital losses to 2013 and beyond, when they can be used to offset gains that otherwise might be subject to the Medicare tax and taxable at the 20% long-term capital gains rate scheduled to return next year.

Reconsider installment sales. If you sell highly appreciated assets this year, you may want to avoid installment arrangements, because they'll defer the gain out over years when the Medicare tax and the higher long-term capital gains tax rate apply. You could be better off recognizing all of the gain in 2012. If you have existing installment arrangements, you might even be able to accelerate payment to realize the gains this year.

Execute Roth IRA conversions. Although distributions from traditional IRAs, 401(k)s and other qualified retirement plans won't be subject to an additional Medicare tax, they'll increase your MAGI and thus could trigger the 3.8% Medicare tax on unearned income. Plus, ordinary-income tax rates are also scheduled to go up in 2013, which means you might pay more taxes on distributions in future years.

Converting such accounts to Roth IRAs will remove future distributions from MAGI and thus reduce exposure to the 3.8% tax. Be aware of the tax consequences of the conversion — converted amounts generally are taxable in the year of conversion — as well as the rules about penalties associated with future withdrawals of the converted funds.

Whether a conversion makes sense for you depends not only on whether future distributions could trigger the additional Medicare tax 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.

CASE STUDY I

Medicare tax impact 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:

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.

Scenario 2. 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 also 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 3.8% tax. The additional tax would be 3.8% × $200,000, or $7,600 — for a total Medicare tax bill of $10,500.

Scenario 3. 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 additional Medicare tax on that income. Why? Because only the amount of net investment income after he hits the $200,000 MAGI threshold is subject to the additional tax. But because his wages are $100,000 less, his total Medicare tax bill is less than Jane's — only $9,050 ($100,000 × 1.45% + $7,600).

Scenario 4. Eric and Anita each have a MAGI of $200,000 in 2013, consisting of $175,000 in wages and $25,000 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. However, Eric and Anita are married. Their combined wages of $350,000 exceed the $250,000 threshold, resulting in a $900 tax (0.9% × $100,000). And because their $400,000 in MAGI exceeds the threshold, their investment income will be subject to a $1,900 tax (3.8% × $50,000). In other words, they'll pay a marriage "penalty" of an additional $2,800 in Medicare taxes.

Itemized deductions for medical expenses

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 applies 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 — starting in 2012 to take advantage of the 7.5% threshold. Controllable expenses might include prescription drugs, eyeglasses and contact lenses, hearing aids, dental work, and elective surgery.

And make sure you're counting *all* qualified expenses. You might be surprised by some of the expenses that may qualify, such as premiums for health insurance and for a qualified long-term care insurance policy (up to certain limits) and payments for transportation to medical care.

New FSA limit

The new year will usher 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.

The upholding of the health care act also means that the provision generally prohibiting the use of tax-free FSA funds to buy over-the-counter drugs, which went into effect last year, will continue. But such funds *can* be used to pay for *prescribed* over-the-counter drugs. So, if, for example, you regularly use over-the-counter medications to treat your allergies, consider asking your doctor to write you a prescription for them.

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 1 at right for information on HSA limits.

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. Also, the prohibition on use of tax-free funds to buy nonprescribed over-the-counter drugs also applies to HSAs.

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 3.8% extra tax on your unearned income, 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.

CHART 1 2012 and 2013 FSA, HSA and HDHP limits

	2012		2013	
	Individual	**Family**	**Individual**	**Family**
FSA annual contribution limit	Set by employer	Same as individual	\$ 2,500[1]	Same as individual
HSA annual contribution limit	\$ 3,100	\$ 6,250	\$ 3,250	\$ 6,450
HSA catch-up[2] contribution limit	\$ 1,000	\$ 1,000	\$ 1,000	\$ 1,000
Minimum HDHP deductible	\$ 1,200	\$ 2,400	\$ 1,250	\$ 2,500
Maximum HDHP out-of-pocket costs	\$ 6,050	\$12,100	\$ 6,250	\$12,500

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

Businesses

Many of the health care act's tax-related provisions will require businesses to take action this year and next. So it's important to take time now to determine how the act affects your business and what you need to do to prepare.

W-2 reporting

A requirement that may affect your business very soon is related to W-2 reporting: Employers that filed 250 or more 2011 W-2 forms must begin reporting the cost of employer-provided health care coverage on the forms beginning with the 2012 tax year — that means the W-2s distributed in January 2013. As explained in IRS Notice 2011-28, the new requirement calls for informational reporting only — it doesn't cause excludable benefits to become taxable or change the tax treatment in any way. The purpose of the requirement is "to provide useful and comparable consumer information to employees on the cost of their health care coverage."

Medicare subsidy payments

As of Jan. 1, 2013, employers can no longer claim an income tax deduction for the Medicare Part D retiree drug subsidy payments they receive from the federal government. Employers should take the loss of the deduction into account in their tax planning.

Medicare tax withholding

Starting in 2013, employers must withhold the aforementioned extra 0.9% in Medicare taxes on employee earnings over \$200,000 (even for married employees). Employers aren't, however, required to match that extra payment; they need pay only 1.45% on all earnings.

The IRS has indicated that employers aren't required to break out the additional withholding amounts on employees' W-2 forms. In fact, to avoid penalties, employers are required to do little more than arrange to withhold the additional amounts. Nonetheless, it's a good idea to alert affected employees that, upon reaching the threshold amount, they'll see a drop in their paychecks.

FSA compliance

As mentioned, employers that offer health care FSAs are currently allowed to set the employee contribution limits for them, but starting in 2013 a \$2,500 limit applies. According to the IRS, this is on a plan year basis.

Thus, non-calendar-year plans must comply for the plan year that starts in 2013. Employers will need to amend their plans and summary plan descriptions to reflect the \$2,500 limit (or a lower one, if they wish) by Dec. 31, 2014, and institute measures to ensure employees don't elect contributions that exceed the limit.

Note that there will continue to be *no* limit on employ*er* contributions to FSAs.

Pay or play provision

The so-called employer mandate provision is scheduled to take effect Jan. 1, 2014. It doesn't *require* employers to provide health care coverage; it in some cases imposes penalties on larger employers that don't offer coverage or that provide coverage that isn't "affordable." Penalties will increase annually based on premium growth.

Employers with 50 or more full-time employees (those working 30 hours or more per week) that don't provide their employees with health coverage will be assessed a penalty if just one of their workers receives a premium tax credit when buying insurance in a health insurance exchange. The annual penalty is $2,000 per full-time employee in excess of 30 workers. For example, if the employer has 53 full-time employees, the penalty would be $46,000 (23 × $2,000).

Employers that do provide coverage could also face penalties if it isn't deemed affordable. Penalties may be triggered if 1) the coverage doesn't cover at least 60% of covered health care expenses for a "typical population," or 2) the premium for the coverage exceeds 9.5% of a worker's income. In such cases, the worker can opt to obtain coverage in an exchange and qualify for the premium credit. If any workers receive the credit, the employer must annually pay the lesser of $3,000 per employee for each employee receiving the credit or $2,000 for each full-time employee beyond the first 30 employees.

Some employers may opt to simply pay the penalties because the increased costs due to the broader scope of coverage now required (for example, coverage of dependents up to age 26) may be greater than the penalties. These employers could incur other costs, though, such as lost tax benefits (unlike health care benefits, penalties aren't deductible) and the costs to remain competitive in the labor market.

Small business tax credits

The health care act provision providing tax credits to qualifying small businesses took effect in 2010. Businesses with fewer than 25 full-time equivalent employees (FTEs) and average annual wages of less than $50,000 that pay at least half of the cost of health insurance for their employees may qualify.

For 2012 and 2013, the credit is for up to 35% of the cost of group health coverage. The maximum credit is available to employers with 10 or fewer FTEs and average annual wages of less than $25,000. Organizations that exceed either threshold are entitled to partial credits on a sliding scale, and the credit is phased out altogether when an organization reaches 25 FTEs or average annual wages of $50,000.

The number of FTEs is determined by calculating the total hours of service for which your business pays wages to employees during the year (but not more than 2,080 for any one employee), and then dividing that figure by 2,080.

Only the employer's portion of health insurance premiums counts in calculating the credit. And that amount is further limited to the amount the employer would have paid based on the average premium for the small group market in the employer's state or area, if it's less than the actual premium. (See Case Study II at left.)

For 2014 and later, small businesses must purchase coverage through their state exchanges to qualify. But the amount of the credit may be higher — as much as 50% of their contributions toward the health insurance premiums.

After 2013, businesses can take the credit for only two years — although there is no requirement for which two years must be chosen. Thus, some planning should be involved in determining when to claim the credit. That is, if the credit will be reduced in a particular year due to one or more of the various limits that apply, the business may be better off waiting until the next year to see if the credit will be more valuable.

Businesses that qualify for the tax credit also will need to determine whether the costs of providing health care coverage are offset by the credit and other benefits of providing coverage.

CASE STUDY II

Calculating the small business credit

For the 2012 tax year, Acme offers its employees a group health plan with single and family coverage and pays 50% of the premiums. Acme has 10 full-time equivalent employees with average annual wages of $23,000. Six employees are enrolled in single coverage and four are enrolled in family coverage. Total premiums are $4,000 a year for single coverage and $10,000 a year for family coverage.

Average premiums for the small group market in Acme's state are $5,000 and $12,000, respectively. Acme's premium payments ($2,000 for single coverage and $5,000 for family coverage) don't exceed 50% of these averages, so it computes the credit based on its actual premium payments of $32,000 (6 × $2,000 + 4 × $5,000). Acme's tax credit is $11,200 ($32,000 × 35%).