

Advisory

PRIVATE CLIENT SERVICES DEPARTMENT | OCTOBER 2012

WIGGIN AND DANA

Affordable Care Act Tax Provisions Scheduled to Take Effect on January 1, 2013

To raise revenue to pay for health care reform, Congress included several tax provisions in the Affordable Care Act that are scheduled to go into effect on January 1, 2013. While it is always possible that Congress will repeal these provisions, planning ahead for the impact of these changes is advisable.

New provisions that are scheduled to take effect on January 1, 2013 include:

- A new tax on unearned income (also known as the “Medicare surtax”);
- An increase in the Medicare portion of the payroll taxes (i.e., FICA) for certain high income taxpayers;
- Lower limits on employer medical flexible spending accounts; and
- An increase in the income threshold for deducting qualified medical expenses on a personal income tax return.

THE UNEARNED INCOME MEDICARE SURTAX.

Of the tax provisions that are intended to help pay for health care reform, the new Medicare surtax on unearned income is the one that has garnered the most attention. It is a new type of tax and, at 3.8%, it has the potential to raise significant sums of money from high-income taxpayers.

For individuals, the new tax is imposed on the lesser of (a) a taxpayer’s “net investment income,” or (b) the amount by which the taxpayer’s modified adjusted gross income (AGI) exceeds a certain threshold. The thresholds are \$200,000 for single filers, \$250,000 for married filers filing jointly, and \$125,000 for married filers filing separately. For most taxpayers, their modified AGI will be the same as their AGI, unless they are U.S. citizens or residents living abroad and have foreign earned income.

For trusts and estates, the new tax applies to the lesser of (1) the entity’s undistributed “net investment income,” or (2) the excess of the entity’s adjusted gross income over the threshold amount at which the entity’s highest tax bracket begins (e.g., \$11,650 for 2012). The tax does not apply, however, to tax-exempt charitable trusts (Code §501(a) trusts) or charitable remainder trusts (Code §664 trusts).

For purposes of the new tax, “investment income” includes dividends, interest, capital gains, royalties, rents, and other income attributable to a passive activity. “Net investment income” is investment income reduced by deductions applicable to that income. Notably, capital gains accrued prior to January 1, 2013, will be subject to the new tax if the gains are not recognized for tax purposes until after December 31, 2012. Capital gain income from

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the sale of a vacation home and from the sale of a principal residence (except to the extent excluded under Code §121) will also be subject to the new tax. (Under Code §121, the first \$250,000 of gain (\$500,000 on certain joint returns) may be excluded if applicable holding periods are met.)

The new tax does not apply to self-employment income or income from a trade or business in which the taxpayer takes an active role, nor does it apply to distributions from tax qualified retirement plans and arrangements (e.g., Code §401(k) plans), individual retirement accounts (“IRAs”) or eligible Code §457 plans. Likewise, the new tax does not apply to nontaxable income, such as tax-exempt interest, life insurance death benefits, municipal bond interest or certain veterans’ benefits.

Taxpayers may want to take steps that will affect their adjusted gross income and their investment income to minimize the impact of this tax. Among the things that taxpayers might consider are the following:

- Invest in tax-exempt bonds, which do not increase AGI and are not subject to the new tax.
- Reduce AGI by increasing deferrals to defined contribution retirement plans, such as Code §401(k) plans, Code §403(b) annuities, and IRAs, or to non-qualified deferred compensation plans.
- Use withdrawals from retirement accounts for living expenses (as opposed to selling securities, which may generate capital gains). Distributions from qualified plans and IRAs will increase AGI, but do not count as investment income. Distributions from Roth IRAs do not increase AGI and are not counted as investment income.
- Make gifts of income-producing property to family members who are expected to have less earned income. (But don’t forget to consider the gift tax and “kiddie tax” implications of any such gift.)
- Establish a charitable remainder trust with appreciated assets. This may allow you to preserve your cash flow with distributions from a diversified portfolio, as well as realize your charitable intentions. Capital gains from the sale of the assets will not be taxable, plus you will be eligible for a current income tax deduction equal to the value ultimately passing to charity.
- Reduce passive activity income by becoming more active in certain business activities, such as real estate rentals, and operate such businesses through an S Corporation.
- Distribute more income from trusts and estates, especially to beneficiaries who are expected to have earned income below the applicable thresholds.

**OTHER TAX PROVISIONS SCHEDULED TO TAKE EFFECT ON
JANUARY 1, 2013***Increase in itemized personal income tax deduction threshold for medical expenses*

Currently, qualified medical expenses must exceed 7.5% of adjusted gross income in order to be deductible. The Affordable Care Act increases this threshold to 10% of adjusted gross income for tax years beginning on and after January 1, 2013, for individuals who are not yet age 65. For those who are at least age 65, the 7.5% threshold will continue to apply until 2017. Note that the deductibility of medical expenses is determined on a year by year basis, so, for example, a person may be subject to the higher threshold in 2013 because he is age 64, the lower threshold in 2014 through 2016 when he is age 65 to 67, and the higher threshold in 2017 when the single threshold for all taxpayers goes into effect.

Medical flexible spending accounts limits imposed

Some employers offer flexible spending accounts ("FSAs") to help employees cover the cost of medical expenses. FSAs are tax-advantaged accounts established in a cafeteria plan maintained by an employer. Typically, an employee will contribute a portion of his or her pre-tax compensation into an FSA, and the employer uses those funds to reimburse the employee for qualified medical expenses that are not otherwise covered by insurance. In effect, this allows the employee to pay for the expense with pre-tax dollars.

Beginning in 2013, the pre-tax compensation an employee may contribute to his or her FSA is limited to \$2,500 (subject to certain cost-of-living adjustments in future years).

The new limitations on FSAs may encourage more employees to enroll in high deductible health plans (HDHPs), if one is offered by their employer. HDHPs are often coupled with Health Savings Accounts (HSAs), which may be funded entirely by an employee or with contributions from the employer. The contribution limits to HSAs are often coordinated with the deductibles under HDHPs. Similar to FSAs, HSAs are tax-advantaged medical savings accounts that can be used to pay for qualified medical expenses on a pre-tax basis. However, unlike FSAs, HSAs do not have an annual "use it or lose it" feature; instead, amounts remaining at the end of the year may be carried forward indefinitely. Moreover, amounts accumulated in an HSA may be used for non-medical expenses, although, if you do so, the amount withdrawn from the account must be included in taxable income, and a penalty is assessed if at the time of withdrawal you are under age 65 and not disabled.

Medicare portion of payroll taxes increased for certain taxpayers

Payroll taxes (also known as "FICA") are imposed on both employees and employers to fund Social Security and Medicare. Currently, the Medicare portion of the payroll taxes consists of 1.45% of wages, which is withheld from employees' pay, and a matching amount contributed by employers. Taxpayers who are self-employed must pay both halves of the tax, but may deduct one-half of the tax as an adjustment to income.

The Affordable Care Act raises the Medicare hospital insurance tax from 1.45% to 2.35% (a 0.9% increase) of wages and self-employment income above a threshold of \$200,000 for single taxpayers and \$250,000 for married taxpayers filing jointly. Employers will not

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Many of our clients, often based upon our advice, have changed their domicile to Florida. While members of our department have always included one or more lawyers licensed to practice in Florida, we have now established relationships with law firms on both coasts of Florida in order to better serve the needs of our clients. For additional information about legal services while you are in Florida, please contact your Wiggin and Dana Private Client Services attorney.

be required to match the increased Medicare tax amounts; however, effective January 1, 2013, employers will be responsible for withholding the additional amounts. Self-employed individuals who meet the income threshold are also subject to the increase, but will not be permitted to deduct the additional tax as a business expense.

Attorneys in our Private Client Services Department would welcome the opportunity to discuss tax planning strategies that may be available to you to minimize the impact of the Affordable Care Act's new tax provisions.

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