Midyear Tax Planning for Healthcare Act Tax Changes Affecting Individuals in 2013

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The 2012 Healthcare Act included several significant tax changes that are scheduled to take effect next year. The recent Supreme Court ruling paves the way for them, and they will kick in automatically unless Congress takes action. As a refresher, the four key changes that can potentially affect individual taxpayers in 2013 and what you can do between now and 12/31/12 to minimize the negative effects on your tax situation. *Depending on how the November election turns out, it is possible that none of these four changes will actually come to pass, but the uncertainty makes tax planning more difficult than ever. With the preceding thoughts in mind, here is what you need to know right now.*

Change No. 1: New $2,500 Cap on Healthcare FSA Contributions

Before the Healthcare Act, there was no tax-law limit on the amount you could contribute each year to your employer's healthcare Flexible Spending Account (FAS) plan. That said, many plans have always imposed their own annual limits. Amounts that you are allowed to contribute to the FSA plan are subtracted from your taxable salary. Then, you can use the FSA funds to reimburse yourself tax-free to cover qualified medical expenses. Good deal! Starting 2013, however, the maximum annual FSA contribution for each employee will capped at $2,500.

Tax Planning Implications: If you have an FSA plan, your employer will ask you near the end of the year to decide how much you want to contribute to your healthcare FSA for 2013. At that point, the new $2,500 contribution limit may affect you. Other than that, just make sure you use up your 2012 contribution before the deadline for doing so. If you are uncertain about the deadline, contact whoever handles payroll and/or employee benefits where you work. Depending on your employer's plan, the deadline for using up your 2012 healthcare FSA contribution may be as late as 3/15/13.

Change No. 2: New Higher Threshold for Itemized Medical Expense Deductions

Before the Healthcare Act, the allowable itemized deduction for unreimbursed medical expenses paid for you, your spouse, and your dependents equaled the excess of your qualified medical expenses over 7.5% of your adjusted gross income (the amount reported on the last line of page 1 of your Form 1040). Starting in 2013, the deduction threshold will be raised to 10% of adjusted gross income (AGI) for most individuals. However, if either you or your spouse will be age 65 or older as of 12/31/13, the new 10%-of-AGI threshold will not take effect until 2017 (in other words, the longstanding 7.5%-of-AGI threshold will continue to apply for 2013-2016). Also, if you or your spouse turns age 65 in any year 2014–2016, the long-standing 7.5%-of -AGI threshold will apply for that year through 2016. Starting in 2017, the 10%-of-AGI threshold will apply to everyone.

Tax Planning Implications: If you will be affected by the new 10%-of-AGI threshold next year, consider accelerating elective qualifying unreimbursed medical expenses into 2012 so that your allowable medical expense deduction for this year will be based on the more taxpayer-friendly 7.5%-of-AGI threshold.

Change No. 3: New 0.9% Medicare Tax on Compensation and/or Self-Employment Income

Currently, the Medicare tax on employee compensation and/or net self-employment (SE) income is 2.9%. If you are an employee, 1.45% is withheld from your paychecks, and the other 1.45% is paid by your employer. If you are self-employed, you pay the whole 2.9% yourself.

Thanks to the Healthcare Act, starting in 2013, an extra 0.9% Medicare tax will be charged on employee compensation and/or net SE income above $200,000 if you are unmarried or $125,000 if you use married filing separate status. If you are married and file jointly, the extra 0.9% Medicare tax will be charged on you and your spouse's combined employee compensation income and/or net SE income above $250,000. These thresholds will not be adjusted for inflation in post-2013 years.

If you are self-employed, the additional 0.9% Medicare tax hit will come in the form of a higher SE bill. However, the additional Medicare tax will not qualify for the deduction for 50% of SE tax that you are allowed to claim on page 1 of your Form 1040.

Finally, if you owe the 0.9% Medicare tax, it should be taken into account in determining if you need to make quarterly estimated tax payments starting in 2013.

Tax Planning Implications: If you have the ability to shift some employee compensation and/or net SE income from 2013 into this year, the new 0.9% Medicare tax will not apply to that amount. However the income shift might have negative effects on your 2012 tax situation, so this is a tricky issue. Contact us if you have questions.

Change No. 4: New 3.8% Medicare Tax on Investment Income

Through 2012, the maximum federal income tax rate on long-term capital gains and dividends is only 15%. Starting in 2013, the maximum rate on long-term gains is scheduled to rise to 20% and the maximum rate on dividends is scheduled to rise to 39.6% as the so-called Bush tax cuts expire.

But that's not all. Starting in 2013, all or part of the net investment income, including long-term capital gains and dividends, collected by higher-income individuals can be hit with an additional 3.8% "Medicare contribution tax." Therefore, the maximum federal rate on long-term gains for 2013 and beyond will actually be 23.8% (versus the current 15%) and the maximum rate on dividends will be 43.4% (versus the current 15%).

The additional 3.8% Medicare contribution tax will not apply unless your modified adjusted gross income (MAGI) exceeds: (1) $200,000 if you are unmarried, (2) $250,000 if you are a married joint-filer, or (3) $125,000 if you use married filing separate status. Furthermore, the additional 3.8% Medicare contribution tax will only apply to the lesser of your net investment income or the amount of MAGI in excess of the applicable threshold.

If you owe the additional 3.8% Medicare contribution tax, it should be taken into account in determining if you need to make quarterly estimated tax payments starting in 2013.

Here are more details on this new tax.

Net Investment Income Defined: Net investment income for purposes of the additional 3.8% Medicare contribution tax is gross investment income less properly allocable deductions. Gross investment income equals the sum of—

Net taxable gains from assets held for investment, including gains from selling stocks and mutual fund shares and the taxable portion of gains from selling personal residences. Gains from property held in a trade or business in which you actively participate (other than the business of trading in financial instruments or commodities) are not included.

Gross income from interest, dividends, annuities, royalties, and rents, unless those items are derived in the ordinary course of a business in which you actively participate (other than the business of trading in financial instruments or commodities). However, interest from tax-exempt bond interest is not included.

Gross income from passive business activities and the business of trading in financial instruments or commodities.

For example, net investment income generally includes the gain on certain real estate transactions. However, it does not include gain on the sale of real property held in your active business. It also does not include the gain on the sale of your principal personal residence to the extent the gain is not taxable because of the $250,000 ($500,000 for married, filing jointly) home gain exclusion. But any gain exceeding the exclusion amount is included in net investment income. Also, if you sell a second home (e.g., vacation home), the entire gain is included in net investment income.

Dividend distributions from an S corporation in which you materially participate are not included in net investment income, nor are gains on the sale of a partnership or S corporation in which you materially participate.

Net investment income does *not* include distributions from tax-favored retirement plans and accounts such as pension plans, 401(k) plans, SEP IRAs, SIMPLE IRAs, traditional IRAs, and Roth IRAs. Social Security benefits are also not included.

Income Threshold and Tax Base: As previously stated, the additional 3.8% Medicare contribution tax will not affect you unless your Modified Adjusted Gross Income (MAGI) exceeds: (1) $200,000 if you are unmarried, (2) $250,000 for a married joint-filing couple, or (3) $125,000 if you use married filing separate status. These thresholds will not be adjusted for inflation in post-2013 years.

MAGI means "regular AGI" from the last line on page 1 of your Form 1040 plus certain tax-free income from foreign sources. For most people, MAGI will be the same as regular AGI. In any case, your MAGI is before any subtractions for personal exemption deductions, the standard deduction if you claim it, or itemized deductions if you claim them. As we said earlier, the good news is that the additional 3.8% Medicare contribution tax will only apply to the *lesser* of: (1) your net investment income or (2) the amount of your MAGI in excess of the applicable threshold (this is referred to as excess MAGI). Confusing? You bet. Here are some examples that will hope will make things more clear.

Example 1: Barry and Sheri, a married joint-filing couple, have 2013 MAGI of $265,000 that includes $60,000 of net investment income. They will owe the 3.8% additional Medicare contribution tax on $15,000 [the lesser of their excess MAGI of $15,000 ($265,000 MAGI less their $250,000 threshold) or their net investment income of $60,000].

Example 2: Harry and Teri, a married joint-filing couple, have 2013 MAGI of $360,000 that includes $60,000 of net investment income. They will owe the 3.8% Medicare contribution tax on $60,000 [the lesser of their excess MAGI of $110,000 ($360,000 MAGI less their $250,000 threshold) or their net investment income of $60,000].

Example 3: Fritz, an unmarried individual, has 2013 MAGI of $180,000 that includes $105,000 of net investment income. He will not owe the 3.8% Medicare contribution tax because his MAGI is below the $200,000 threshold for unmarried taxpayers.

Example 4: Mary, a well-off widow, sells her principal residence for a $700,000 gain in 2013. Thanks to the $250,000 federal home sale gain exclusion break for unmarried individuals, her taxable gain is "only" $450,000 ($700,000–$250,000). In 2013, Mary also has $290,000 of income from other sources including $65,000 of net investment income from capital gains, dividends, interest, and so forth. Mary's 2013 MAGI is $740,000 ($450,000 from the home sale gain plus $290,000 from other sources). She will owe the 3.8% Medicare contribution tax on the entire amount of her net investment income of $515,000 ($450,000 from the home sale gain plus $65,000 from other sources) because $515,000 is the lesser of Mary's excess MAGI of $540,000 ($740,000 MAGI less her $200,000 threshold) or her net investment income of $515,000.

Impact on Trusts: For a trust, the additional 3.8% Medicare contribution tax will apply to the *lesser* of: (1) undistributed net investment income or (2) the amount of AGI in excess of the threshold for the top trust federal income tax bracket. For 2013, that threshold will probably be about $12,000. Therefore, lots of trusts may be exposed to the new tax.

Impact on Maximum Tax Rates: Thanks to the additional 3.8% Medicare contribution tax in conjunction with rate increases from the scheduled demise of the Bush tax cuts, the following maximum federal rates will apply in 2013 unless something changes:

23.8% (20% + 3.8%) on long-term capital gains in excess of short term capital losses (versus 15% for 2012).

43.4% (39.6% + 3.8%) on short-term capital gains in excess of long term capital losses (versus 35% for 2012).

43.4% (39.6% + 3.8%) on ordinary income from dividends, interest, rental activities, royalties, and annuities not derived from your active business (versus 15% on qualified dividends for 2012 and 35% on the other types of income for 2012).

43.4% (39.6% + 3.8%) on ordinary income from passive business activities and ordinary income from the business of trading in financial instruments or commodities (versus 35% for 2012).

Planning Implications: Investment gains that would be subject to these higher tax rates if they are recognized in 2013 won't be hit with the higher tax rates if you trigger the gains this year. Therefore, consider triggering gains by selling affected appreciated assets by 12/31/12 instead of hanging onto them. That said, the tax tail should not wag the investment dog. You should only sell assets that you are thinking about selling anyway.

Since tax exempt interest is not subject to the 3.8% Medicare contribution tax while taxable interest is, now may be a good time to review your investment portfolio to see if investing in tax exempt municipal bonds might make sense. Retirement plan distributions are also exempt from the 3.8% Medicare contribution tax, so it may pay to maximize your contributions to these accounts.

You may also want to do things that would increase your AGI (such as a Roth IRA conversion or a retirement account withdrawal) this year instead of next year. Doing so will reduce or eliminate your exposure to the additional 3.8% Medicare contribution tax next year. Contact us if you want more information on this new tax and ideas on how to minimize it.

Conclusion

As we said earlier, none of these unfavorable Healthcare Act tax changes may actually come to pass. If they are cancelled, however, it certainly won't happen until after the election on November 6th. So be prepared to pull the trigger on some tax planning moves around year-end. We will be here to help with that.

If you would like to discuss tax planning or have any additional questions, Please contact me.

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