FINANCIAL PLANNING UPDATE

US Supreme Court Upholds Health Care Law

What Does It All Mean?

BMO HARRIS FINANCIAL ADVISORS, INC.

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Health Care Law Provisions

This summer, the Supreme Court ruled on the constitutionality of the Patient Protection and Affordable Care Act (PPACA) and the Health Care and Education Reconciliation Act (HCERA). Together, these tax acts have been referred to in the press as "Obamacare." The court decision side-stepped the issue of whether the government could require a citizen to purchase health insurance. It did confirm, however, that the government had a right to assess a penalty (under its power to levy taxes) if a) one went without health insurance, or b) if an employer with 50 or more employees did not provide coverage. The requirement to have health insurance starts on January 1, 2014.

In addition, several other provisions take effect over the coming months – including new Medicare taxes starting January 1, 2013 and the possible expiration of the long-standing Bush tax cuts – which warrant attention and may suggest for some a tax-related move prior to year-end. There is a lot to consider, but doing so now may provide a much brighter financial future.

New Medicare Taxes – January 2013

Two new Medicare tax provisions take effect on January 1, 2013. The first is a 0.9% rate increase on wages and self employment income in excess of $200,000 for an individual or $250,000 combined for a married couple filing jointly ($125,000 married-filing-separate). The second is a 3.8% tax on investment income for taxpayers with modified adjusted gross income (MAGI) in excess of $200,000 for single filers and $250,000 for married couples filing a joint return. Let's take a closer look at each.

Currently, Medicare taxes apply to wages and self employment income. If self employed, the current tax rate is 2.9%. As an employee, half of this amount is paid by the employee and the remaining half, 1.45%, is paid by the employer. Beginning January 1, 2013, an additional 0.9% Medicare tax on wages and self employment income in excess of the $200,000 / $250,000 threshold is payable by the taxpayer. The following illustrates this increase:

	SINGLE FILER	JOINT FILER	MARRIED - FILING - JOINTLY		
			Taxpayer	Spouse	Combined
Taxpayer Wages	$300,000	$250,000	$250,000	—	$250,000
Spouse Wages	—	$50,000	—	$50,000	$50,000
Total Wages	$300,000	$300,000	$250,000	$50,000	$300,000
Threshold	($200,000)	($250,000)	($125,000)	($125,000)	($250,000)
Amount Above Threshold	$100,000	$50,000	$125,000	—	$50,000
Additional Tax at 0.9%	$900	$450	$1,125	—	$450

Furthermore, if a taxpayer exceeds these thresholds from a single employer, the employer is required to withhold the tax. However, as the tax is on all wages and self employment earned by the taxpayer (and their spouse if filing a joint return) over the threshold, it is still possible this tax would not be withheld. This may require the payment of additional tax installments throughout the year to avoid exposure to penalties for underpayment. Consider the following example with $400,000 of total income. The first column assumes all the income is earned by one taxpayer / one employer. The second column shows an even split between the taxpayer and spouse or from two separate employers.

	JOINT FILER 1	JOINT FILER 2
Taxpayer Wages	$400,000	$200,000
Spouse Wages	—	$200,000
Total Wages	$400,000	$400,000
Threshold	($250,000)	($250,000)
Amount Above Threshold	$150,000	$150,000
Additional Tax at 0.9%	$1,350	$1,350
Amount Withheld	($1,350)	—
Additional Tax Owed	—	$1,350

For many business owners, the decision on taking income as wages versus reporting the income as business income has been a matter of tradeoff. This new rule adds another wrinkle to the decision process as business earnings are not subject to this additional Medicare tax. ***On the surface, this would suggest that a business owner pays himself a smaller salary and takes more income as business earnings.*** However, there are already discussions within Congress to subject all active business income to self-employment taxes to avoid this potential abuse.

Regarding the new 3.8% tax on investment income for taxpayers with MAGI in excess of $200,000 for single filers and $250,000 for married couples filing a joint return, the tax applies only to the lesser of the investment income or the MAGI above the threshold amount as the following illustrates:

	JOINT FILER 1	JOINT FILER 2	JOINT FILER 3
1- Investment Income	$50,000	$50,000	$50,000
2- Other Income	$200,000	$225,000	$250,000
3- Total Income	$250,000	$275,000	$300,000
4- Threshold Amount	($250,000)	($250,000)	($250,000)
5- Amount Above Threshold	—	$25,000	$50,000
6- Lesser of 1 or 5	—	$25,000	$50,000
7- 3.8% Tax on Line 6	—	$950	$1,900

Investment income includes interest, dividends, annuities, royalties and rents (not a complete list). Also, if you sell your residence and have a gain (net of the $250,000 / $500,000 gain exclusion about which you should consult with your wealth advisor), this could also be subject to the new Medicare tax. Excluded from "investment income" is income earned in an active trade or business, or distributions from retirement plans and IRAs. While not directly subject to the Medicare tax, distributions from retirement plans could cause AGI to increase to the point where the Medicare tax on investment income is triggered as illustrated in the following:

	JOINT FILER 1	JOINT FILER 2
1- Investment Income	$50,000	$50,000
2- Other Income	$200,000	$200,000
2b- Retirement Plan Distributions	—	$75,000
3- Total Income	$250,000	$325,000
4- Threshold Amount	$250,000	($250,000)
5- Amount Above Threshold	—	$75,000
6- Lesser of 1 or 5	—	$50,000
7- 3.8% Tax on Line 6	—	$1,900

FEDERAL TAX RATES	2012	2013 "BUSH TAX CUTS" EXPIRATION	2013 PLUS NEW MEDICARE TAXES	POTENTIAL TAX INCREASE (AS A %)
Interest	35.00%	39.60%	43.40%	24.00%
Qualified Dividends	15.00%	39.60%	43.40%	189.33%
Long Term Capital Gains	15.00%	20.00%	23.80%	58.67%

Possible Expiration of 2001 and 2003 "Bush" Tax Cuts

Another tax hit may be on the horizon beginning in 2013 with even greater potential impact if Congress allows the 2001 and 2003 tax cuts to expire at year-end. The table below summarizes the changes in top tax rates on different types of income from 2012 to 2013 if the so-called Bush tax cuts are allowed to expire.

One strategy for consideration is to accelerate long-term capital gains before year-end 2012. Unlike "loss harvesting" where you must wait 30 days after the sale to repurchase an investment sold to generate a tax loss, you could sell an investment at a gain, lock in the tax rate for the holding period to date and then repurchase the investment immediately. Then, only future gains would be subject to the higher tax rate. Whether or not this strategy is sound depends on the expected future return and holding period for the investment. ***Additionally, for those over age 59½, consideration of an IRA distribution strategy in 2012 to keep future income below thresholds may be warranted.*** As Paul Tromp mentioned in last quarter's Financial Planning Update, deferral of taxes is not always the lowest cost income tax strategy.

Changes in Deductions and Exclusions

One more change coming in 2013 about which taxpayers should be aware involves Flexible Spending Accounts (FSA). FSAs are employee benefit plans that allow a taxpayer to elect to deduct funds before taxes to be placed in an account to be used exclusively for qualified medical expenses. Currently, the limit for deductions is $5,000. This amount will be lowered to $2,500 beginning January 1, 2013. Beginning in 2014, this amount will be adjusted annually for inflation. Rules regarding FSAs were also tightened. Prior to 2011, FSAs could be used to purchase over-the-counter medicines. Now, these can only be paid from an FSA if prescribed by a doctor.

2014 Changes – Mandatory Insurance Coverage and Penalty

Beginning in 2014, individuals must carry minimum levels of health insurance on themselves and their dependents. Individuals on Medicaid or Medicare are exempt from this requirement. The penalty for not having coverage will be $95 for 2014 (or 1% of income above the income tax filing threshold, if higher), $325 or 2% for 2015 and $695 or 2.5% in 2016 with adjustments for inflation after 2016.

	2014	2015	2016
Penalty - Flat Rate	$95	$325	$695
Income	$50,000	$50,000	$50,000
Threshold (2012/married)*	($19,500)	($19,500)	($19,500)
Income Above Threshold	$30,500	$30,500	$30,500
Percentage Penalty	1.0%	2.0%	2.5%
Penalty Based on Percentage	$305	$610	$763
Greater of Flat or Percentage Based	$305	$610	$763

Beginning in 2014, there is also a Premium Assistance Tax Credit for taxpayers with household income between 100% and 400% of the federal poverty level ($23,052 - $92,208 annual income for a family of four in 2012).

Large employers (50 or more full-time equivalent employees) must provide health insurance coverage to their employees beginning in 2014 or pay a penalty.

**2014-2016 filing thresholds not known at this time.*

The penalty for not providing coverage is $2,000 per employee after the first 30 employees. However, even if the employer offers coverage, if any employee would be qualified for the premium assistance tax credit (see previous page), the employer could be required to pay up to $3,000 per eligible employee, but no more than the penalty for not providing insurance. ***For small business owners, this has the potential of making the decision to move from 49 to 50 employees more difficult.***

	NO COVERAGE	COVERAGE OFFERED	COVERAGE OFFERED
No. of Employees	50	50	50
Exemption	(30)	(30)	(30)
Total	20	20	20
Penalty ($2,000)	$40,000	$40,000	$40,000
Eligible for P.A.T.C.	—	—	10
Penalty ($3,000)	—	—	$40,000
Lower of Penalties	—	—	$30,000

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Conclusion

Year-end tax uncertainty has been commonplace over the last decade. As 2012 winds down, the combination of Medicare tax changes, potential income tax rate hikes, mandatory health coverage and its effects and a questionable economic outlook may feel like too much to consider. Work with your financial advisor and tax specialist to review your current financial profile and what's on the horizon. A detailed assessment and possible year-end action could prove extremely beneficial down the road.

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