Marks Paneth & Shron LLP
Certified Public Accountants & Consultants
IT ALL ADDS UP.

MP&S TAX ALERT: INDIVIDUAL TAX PLANNING IN THE AFTERMATH OF THE SUPREME COURT'S HEALTH CARE LAW RULING

Since the US Supreme Court issued its health care law ruling, most of the attention has focused on its mandates, expansion of coverage and state insurance exchanges. But the Patient Protection and Affordable Care Act of 2010 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.

Now is the time to start planning so you can minimize any negative tax consequences to the extent possible.

Medicare Taxes

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.

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 December 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 an S corporation shareholder-employee, 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 us 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 transaction costs 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, which will defer the gain out over years when the Medicare tax and the higher long-term capital gains tax rate apply. You may be better off opting to recognize all of the gain in 2012. If you have existing installment arrangements, you may want to see if you can accelerate payment to realize the gains this year.

***Execute Roth IRA conversions*.** Although distributions from traditional IRAs, 401(k)s or 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 0.9% 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.

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

FSAs

The new year also will usher in a $2,500 limit on pretax employee contributions to Flexible Spending Accounts (FSAs) for health care. The limit will be increased annually by the cost-of-living adjustment. For 2012 and earlier, employers set the limits, so your 2012 limit may be higher.

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. However, be aware that 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, you may want to talk to your doctor about writing a prescription for them.

If you're concerned about the $2,500 FSA limit and aren't currently contributing to a Health Savings Account (HSA), you may want to look into whether you're eligible. To contribute to an HSA, you must be covered by qualified high-deductible health insurance. An HSA allows contributions of pretax income (or deductible after-tax contributions) up to $3,100 for self-only coverage and $6,250 for family coverage (for 2012). Account holders age 55 and older can contribute an additional $1,000.

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 be aware that the prohibition on use of tax-free funds to buy nonprescribed over-the-counter drugs also applies to HSAs.

An HSA also can provide a way to do some "after-the-fact" Medicare tax planning: You have until the April filing deadline to make your contribution, or to add to the amount that your employer contributes on your behalf. So, if 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, you may want to make them aware of the penalty they may face if they don't obtain coverage.

Do the Math

The health care act's many tax provisions combined with other scheduled tax increases mean that many taxpayers will benefit from running cost comparisons to determine the best path forward. Contact us for help conducting a comprehensive analysis that considers all of the relevant factors to determine the smartest tax planning moves for you to make this year.

MP&S ONLINE TAX GUIDE

To facilitate ongoing access to the latest tax rules and regulations, Marks Paneth & Shron offers an online tax guide that is updated as changes occur. Please visit http://www.webtaxguide.net/markspaneth/ to access the guide.

FOR MORE INFORMATION

If you have any questions about the information contained in this alert, please contact your MP&S advisor or:

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