

# Health Care Reform – 2010

*Summary of Major Provisions Potentially Impacting the High Net Worth Taxpayer*

**Wealth Advisory Center, GenSpring Family Offices**

Following up on his pledge to address the problems of rising health care costs and the increasing number of Americans without adequate health insurance, President Obama recently signed into law sweeping new health care legislation. This legislation is designed to provide near universal health insurance coverage to Americans and includes provisions which encourage employers to provide health insurance, prevent insurance companies from denying coverage based on pre-existing conditions, and allow adult children to remain on their parents' health insurance longer.

The following is an introduction to some of the more significant provisions, both tax and non-tax, that could potentially impact GenSpring families.

## **Medicare Taxes – Beginning January 2013**

One of the largest revenue raisers in the legislation comes from Medicare tax hikes. Beginning January 2013, two independent taxes emerge that will significantly increase the Medicare tax burden on high net worth individuals. While these are two separate taxes, many high net worth taxpayers will be impacted by both taxes.

### ***Increased Payroll Tax***

The first is a .9% increase in the Medicare Payroll Tax imposed on employees or self-employed individuals with wages or earnings related to employment above certain thresholds. The threshold is \$200,000 for individual taxpayers and \$250,000 for married taxpayers filing jointly. For example, a single taxpayer with wages of \$1,000,000 would see an increase of \$7,200 ( $\$1,000,000$  wages less \$200,000 threshold x .9%). Importantly,

there is no cap on amounts subject to this tax, and the threshold amounts are not indexed for inflation. Also worth noting is that the law does not allow the employer to take into account earnings of a spouse when calculating the withholding. This could create an 'under-withheld' scenario if the wage of each spouse is below the threshold, but combined wages exceed the \$250,000 threshold. In this case, the employee would be liable for any deficiency.

### ***Unearned Income Medicare Contribution***

The most significant tax provision from the perspective of the high net worth taxpayer is likely the creation of a 3.8% Medicare contribution tax on unearned income. This tax applies to unearned income of individuals, estates and trusts above certain thresholds. The threshold amount is \$200,000 for single taxpayers and \$250,000 for married

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taxpayers filing jointly, and these amounts are not indexed for inflation. The tax is equal to 3.8% of the lesser of (1) the taxpayer's "net investment income", or (2) the excess of "modified adjusted gross income" over the threshold amount. "Net investment income" includes interest, dividends, annuities, rents, royalties, income derived from passive activities and net capital gains

derived from the disposition of property (excluding property held in an active trade or business). Notably absent from this definition are distributions from IRAs or qualified plans and tax-exempt income such as municipal bond interest.<sup>1</sup> The following are three examples of how these concepts apply to individual taxpayers:

### Example 1:

In 2013 a single taxpayer has the following items of income:

\$100,000 Net Investment Income

\$120,000 Salary

\$220,000 Modified Adjusted Gross Income (MAGI)

The unearned income medicare contribution would only apply on the \$20,000 amount by which her MAGI exceeds her threshold amount of \$200,000, because that is less than her net investment income of \$100,000. Thus, the tax would equal \$760 ( $\$20,000 \times 3.8\%$ ).

### Example 2:

In 2013 a single taxpayer has the following items of income:

\$100,000 Net Investment Income

\$200,000 Salary

\$300,000 Modified Adjusted Gross Income (MAGI)

Because taxpayer's MAGI exceeds her threshold amount by \$100,000, she would pay a surtax on her full \$100,000 of net investment income. Thus, the tax would equal \$3,800 ( $\$100,000 \times 3.8\%$ ).

### Example 3:

In 2013 a single taxpayer has the following items of income:

\$1,000,000 Net Investment Income

\$100,000 Salary

\$1,100,000 Modified Adjusted Gross Income (MAGI)

Taxpayer would pay a surtax on the amount by which the MAGI exceeded the threshold amount because this amount is less than her net investment alone. Thus, tax would be \$34,200 ( $\$900,000 \times 3.8\%$ ).

<sup>1</sup> Although distributions from IRAs and qualified plans are not considered "net investment income" and will therefore not be subject to the 3.8% surtax, distributions from traditional IRAs and qualified plans are included in "modified adjusted income" potentially increasing it over the threshold amount. Note distributions from Roth IRAs are not included in modified adjusted gross income.

This tax applies similarly to the unearned income of trusts and estates, except that the threshold amount is set equal to the dollar amount at which the highest estate and trust income tax bracket begins, currently \$11,200. Note this lower threshold amount makes the 3.8% surtax more punitive for trusts and estates than for individual taxpayers. Trusts that distribute all current income will likely not be impacted since they would have no “net investment income.” Instead, the tax would apply at the beneficiary level according to the individual rules discussed above. Similarly, there should be no trust level surtax for trusts treated as “grantor trusts” for federal income tax purposes. Instead, the surtax should apply to the grantor under the individual rules discussed above.<sup>2</sup>

### **Individual Health Insurance Mandate**

Beginning January 2014, individuals must obtain and keep “minimum essential coverage” to avoid a penalty. This coverage can come from either eligible government programs (for example Medicare or Medicaid) or any plan offered in the marketplace. Lower income individuals as well as some middle income families may qualify for a premium assistance tax credit, cost sharing arrangements or vouchers to help pay for the health insurance.

### **Immediate Changes to Employer Sponsored Group Health Insurance Plans**

Beginning in late 2010, the law requires a number of plan design changes to employer provided group health insurance plans. Perhaps most significantly, the law requires these plans to eliminate both lifetime and annual limits on benefits. The law also creates a temporary national pool for people denied insurance due to preexisting conditions.

Covered plans will also be required to cover the first-dollar spent on preventative care. Finally, covered plans that provide coverage for a dependent child must cover the child until he or she reaches age 26.<sup>3</sup>

### **Medical Expense Deduction**

Under current law, for regular income tax purposes, an individual who itemizes deductions can deduct certain unreimbursed medical expenses paid during the year to the extent they exceed a threshold amount of 7.5% of adjusted gross income. For Alternative Minimum Tax Purposes, the threshold is 10% of adjusted gross income. Given these thresholds, it is rare for high net worth or high income taxpayers to deduct unreimbursed medical expenses.

Beginning in January 2013 the law raises the threshold for regular tax purposes to 10% of adjusted gross income. It does not change the rules for Alternative Minimum Tax purposes. Also note that special rules keep the threshold at 7.5% for 2013 through 2016 if the taxpayer or the taxpayer’s spouse turns 65 during the tax year. This change will make it more difficult for high net worth or high income taxpayers to deduct unreimbursed medical expenses.

### **Flexible Spending Account Changes**

Beginning in January 2011, the law modifies the definition of qualified medical expenses to exclude over-the-counter medications that were allowed under prior law, and increases the additional tax on non-qualified distributions from 10% to 20%. Beginning in 2013, the legislation limits contributions to Flexible Spending Accounts (FSAs) to \$2,500 per tax year.

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<sup>2</sup> Charitable Remainder Trusts (CRTs) and tax-exempt trusts are excluded from the surtax.

<sup>3</sup> Note there is no requirement for a plan or issuer to provide health insurance coverage for anyone, including dependents. But if coverage is provided for dependent children, then the coverage must continue until the dependent child turns 26.

We have focused this discussion primarily on how this legislation impacts the high net worth individual. Keep in mind that the legislation also has major implications for both small and large businesses, non-profit hospitals, pharmaceutical importers and manufactures, medical device manufacturers and healthcare providers. We will continue to monitor and digest these provisions as they are phased in over the next several years. If you have questions regarding how these provisions may impact you or your business please contact your GenSpring advisor.

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