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June 16, 2010

Re: Tax Implications of Healthcare Reform

Dear Client:

With the enactment of the Patient Protection and Affordable Care Act on March 23, 2010, the American healthcare landscape was altered in dramatic fashion. The effects of the Act are likely to be pervasive, impacting individuals and businesses alike. In this letter, we offer a summary of the provisions of the Act that we believe are most relevant to our clients.

By 2014, the overall effect of the Act will be that all individuals not covered by Medicare or Medicaid will be required to obtain healthcare coverage or face a penalty. Employer-provided coverage generally will satisfy this requirement, and individuals and families with lower income levels may receive a tax credit to help pay for coverage. Employers that do not provide coverage will be subject to an additional tax, but employers with fewer than 25 employees will receive tax credits as an incentive to provide coverage. The Act also contains provisions that are designed to eliminate unreasonable limitations on benefits, prohibit the rescission of coverage, provide assistance to those with pre-existing medical conditions, and extend coverage for dependents to age 26.

Nevertheless, the Act contains a number of tax changes which will be implemented over a nine-year period. The following is a brief overview of some of these changes.

2010

- **Dependent coverage in employer health plans.** Effective on March 30, 2010, the Act extended the general exclusion for reimbursements for medical care expenses under an employer-provided accident or health plan to any dependent of an employee who has not attained age 27 as of the end of the tax year. Also, self-employed individuals are permitted to take a deduction for the health insurance costs of any dependent who has not attained age 27 by the end of the tax year.
- **Liberalized adoption credit and adoption assistance rules.** The maximum adoption credit is increased to \$13,170 per eligible child (a \$1,000 increase) for both non-special needs adoptions and special needs adoptions. The adoption credit is refundable.
- **Excise tax on indoor tanning services.** The Act imposes a 10% excise tax on indoor tanning services. The tax, which will be paid by the individual on whom the tanning services are performed, but collected and remitted by the person receiving payment for the tanning services, will take effect on July 1, 2010.

2011

- **Limit reimbursement of over-the-counter medications from HSAs, FSAs, and MSAs.** The Act excludes the cost of over-the-counter drugs not prescribed by a doctor from being reimbursed through a health reimbursement account (HRA) or health flexible spending account (FSA) and from being reimbursed on a tax-free basis through a health savings account (HSA) or Archer Medical Savings Account (MSA).
- **Increased penalties on nonqualified distributions from HSAs and Archer MSAs.** The Act increases the tax on distributions from a health savings account or an Archer MSA that are not used for qualified medical expenses to 20% (from 10% for HSAs and 15% for Archer MSAs) of the disbursed amount.
- **Form W-2 must include cost of employer-provided health insurance.** For purposes of tracking the cost of employer-provided coverage, employers must disclose on each employee's annual Form W-2 the value of the employee's health insurance coverage sponsored by the employer.

2012

- **Information reporting required for business payments made to corporations.** For payments made after December 31, 2011, businesses (including self-employed individuals) that pay any amount greater than \$600 during the year to non-tax-exempt corporate providers of property and services will have to file an information report (Form 1099) with the providers and with the IRS. To ease concerns over any burdens this may impose on businesses, the Commissioner of Internal Revenue has indicated that the IRS plans to use its administrative authority to exempt from this new requirement business transactions conducted using payment cards such as credit and debit cards. These transactions already will be covered by a new reporting requirement on payment card processors, so there will be no need for businesses to report them as well.

2013

- **Higher Medicare taxes on high-income taxpayers.** High-income taxpayers will be hit with both a tax increase on wages and a new levy on investment income.
 - *Higher Medicare payroll tax on wages.* The Medicare payroll tax is the primary source of financing for Medicare's hospital insurance trust fund, which pays hospital bills for beneficiaries, who are age 65 and older or disabled. Under current law, wages are subject to a 2.9% Medicare payroll tax. Workers and employers pay 1.45% each. Self-employed individuals pay both halves of the tax but are allowed to deduct half of this amount for income tax purposes. Unlike the payroll tax for Social Security, which applies to earnings up to an annual ceiling (\$106,800 for 2010), the Medicare tax is levied on all of a worker's wages without limit. Under the provisions of the Act, single people earning more than \$200,000 and married couples earning

more than \$250,000 will be taxed an additional 0.9% (2.35% total) on the excess over those base amounts. Self-employed persons will pay 3.8% on earnings over the threshold. It also should be noted that the \$200,000/\$250,000 thresholds are not indexed for inflation, so it is likely that more and more people will be subject to the higher taxes in coming years.

- *Medicare payroll tax extended to investments.* Under current law, the Medicare payroll tax applies only to wages. Beginning in 2013, a Medicare tax will for the first time be applied to investment income. A new 3.8% tax will be imposed on the lesser of either (1) net investment income or (2) the excess of modified adjusted gross income over the \$200,000/\$250,000 threshold amount. Net investment income includes interest, dividends, annuities, rents, royalties, gross income from passive activities, and net gain from the disposition of property (other than property held in a trade or business). Income does not include items such as tax-exempt interest, veterans' benefits, and excluded gain from the sale of a principal residence. Net investment income is reduced by properly allocable deductions to such income. The new tax will not apply to income in tax-deferred retirement accounts such as 401(k) plans and IRAs.
- **Higher threshold for deducting medical expenses.** Under current law, taxpayers can take an itemized deduction for unreimbursed medical expenses for regular income tax purposes only to the extent those expenses exceed 7.5% of the taxpayer's AGI. The Act raises the floor beneath itemized medical expense deductions from 7.5% of AGI to 10%. The AGI floor for individuals age 65 and older (and their spouses) will remain unchanged at 7.5% through 2016.
- **Dollar cap on contributions to health FSAs.** A flexible spending account is one of a number of tax-advantaged financial accounts that can be set up through a cafeteria plan of an employer. An FSA allows an employee to set aside a portion of his or her earnings to pay for qualified expenses, most commonly for medical expenses. Under current law, there is no limit on the amount of contributions to an FSA. Under the Act, however, allowable contributions to health FSAs will be capped at \$2,500 per year. The dollar amount will be indexed for inflation after 2013.

2014

- **Individuals not carrying health insurance face a penalty.** The Act contains an "individual mandate" – a requirement that U.S. citizens and legal residents have qualifying health coverage or be subject to a tax penalty. Those without minimum essential coverage will pay a tax penalty of the greater of (a) \$695 per year, up to a maximum of three times that amount (\$2,085) per family, or (b) 2.5% of household income over the threshold amount of income required for filing an income tax return. The fee for an uninsured individual under age 18 will be one-half of the adult fee. The penalty is phased in according to the following schedule: \$95 in 2014, \$325 in 2015, and \$695 in 2016 for the flat fee; or 1.0% of taxable income in 2014, 2.0% in 2015, and 2.5% in 2016. Beginning after 2016, the penalty will be

increased annually by a cost-of-living adjustment. Exemptions will be granted for financial hardship, religious objections, Native Americans, those without coverage for less than three months, aliens not lawfully present in the U.S., incarcerated individuals, those for whom the lowest cost plan option exceeds 8% of household income, those with incomes below the tax filing threshold, and nonresidents.

- **Premium assistance tax credits for purchasing health insurance.** One of the key aspects of the healthcare legislation is its provision of tax credits to low- and middle-income individuals and families for the purchase of health insurance. The Act creates a refundable tax credit for eligible individuals and families who purchase health insurance through an “Exchange.” The premium assistance credit, which is refundable and payable in advance directly to the insurer, subsidizes the purchase of certain health insurance plans through an Exchange. The premium assistance credit will be available for individuals and families with incomes up to 400% of the federal poverty level that are not eligible for Medicaid, employer-sponsored insurance, or other acceptable coverage. The credits will be available on a sliding-scale basis. The amount of the credit will be based on the percentage of income that the premiums represent, rising from 2% of income for those at 100% of the federal poverty level to 9.5% of income for those at 400% of the federal poverty level.

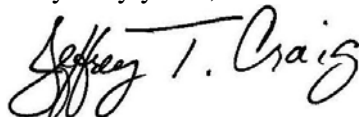
2018

- **Excise tax applies to high-cost, employer-provided coverage.** A 40% nondeductible excise tax will be levied on insurance companies and plan administrators for employer-sponsored health coverage to the extent that annual premiums exceed \$10,200 for single coverage and \$27,500 for family coverage. An additional threshold amount of \$1,650 for single coverage and \$3,450 for family coverage will apply for retired individuals age 55 and older and for plans that cover employees engaged in high-risk professions.

Because many of the above provisions will not take effect until later years, we can expect refinements and clarifications to occur in the future. Certain provisions, including the higher Medicare tax and the excise tax on high-cost plans, are particularly vulnerable to change. Of course, we will continue to monitor these and other tax-related developments and incorporate them into our wealth-management strategies.

We appreciate the opportunity to be of service to you.

Very truly yours,



Jeffrey T. Craig, CFP[®], Enrolled Agent
Director of Tax Services

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