

May 24, 2010

Dear Client,

As I'm sure you're aware, there have been two significant pieces of legislation passed so far in 2010. We'd like to give you an overview of the key tax changes affecting both individuals and small businesses in the recently enacted Health Care and Education Reconciliation Act of 2010 (Reconciliation Act) and the Hiring Incentives to Restore Employment Act (HIRE Act).

RECONCILIATION ACT:**(Individuals)**

Individual mandate. The new law contains an "individual mandate"—a requirement that U.S. citizens and legal residents have qualifying health coverage or be subject to a tax penalty. Under the new law, those without qualifying health 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 income tax return filing. The penalty will be 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% of taxable income in 2015, and 2.5% of taxable income 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, American Indians, 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 (in 2010 the threshold for taxpayers under age 65 is \$9,350 for singles and \$18,700 for couples), and those residing outside of the U.S.

Premium assistance tax credits for purchasing health insurance. The centerpiece of the health care legislation is its provision of tax credits to low and middle income individuals and families for the purchase of health insurance. For tax years ending after 2013, the new law creates a refundable tax credit (the "premium assistance 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. Under the provision, an eligible individual enrolls in a plan offered through an Exchange and reports his or her income to the Exchange. Based on the information provided to the Exchange, the individual receives a premium assistance credit based on income and the IRS pays the premium assistance credit amount directly to the insurance plan in which the individual is enrolled. The individual then pays to the plan in which he or she is enrolled the dollar difference between the premium assistance credit amount and the total premium charged for the plan. For employed individuals who purchase health insurance through an Exchange, the premium payments are made through payroll deductions.

The premium assistance credit will be available for individuals and families with incomes up to 400% of the federal poverty level (\$43,320 for an individual or \$88,200 for a family of four, using 2009 poverty level figures) 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 the cost of premiums represents, rising from 2% of income for those at 100% of the federal poverty level for the family size involved to 9.5% of income for those at 400% of the federal poverty level for the family size involved.

Higher Medicare taxes on high-income taxpayers. High-income taxpayers will be hit with a double whammy: a tax increase on wages and a new levy on investments.

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 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 people 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 new law, which take effect in 2013, most taxpayers will continue to pay the 1.45% Medicare hospital insurance tax, but single people earning more than \$200,000 and married couples earning more than \$250,000 will be taxed at an additional 0.9% (2.35% in total) on the excess over those base amounts. Employers will collect the extra 0.9% on wages exceeding \$200,000 just as they would withhold Medicare taxes and remit them to the IRS. Companies wouldn't be responsible for determining whether a worker's combined income with his or her spouse made them subject to the tax. Instead, some employees will have to remit additional Medicare taxes when they file income tax returns, and some will get a tax credit for amounts overpaid. Self-employed persons will pay 3.8% on earnings over the threshold. Married couples with combined incomes approaching \$250,000 will have to keep tabs on their spouses' pay to avoid an unexpected tax bill. It should also 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 only applies 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 net investment income of single taxpayers with AGI above \$200,000 and joint filers over \$250,000 (unindexed). Net investment income is interest, dividends, royalties, rents, gross income from a trade or business involving passive activities, and net gain from disposition of property (other than property held in a trade or business). Net investment income is reduced by properly allocable deductions to such income. However, the new tax won't apply to income in tax-deferred retirement accounts such as 401(k) plans. Also, the new tax will apply only to income in excess of the \$200,000/\$250,000 thresholds. So if a couple earns \$200,000 in wages and \$100,000 in capital gains, \$50,000 will be subject to the new tax. Because the new tax on investment income won't take effect for three years, that leaves more time for Congress and the IRS to tinker with it. So we can expect lots of refinements and "clarifications" between now and when the tax is actually rolled out in 2013.

Floor on medical expenses deduction raised from 7.5% of adjusted gross income (AGI) to 10%. Under current law, taxpayers can take an itemized deduction for unreimbursed medical expenses for regular income tax purposes only to the extent that those expenses exceed 7.5% of the taxpayer's AGI. The new law raises the floor beneath itemized medical expense deductions from 7.5% of AGI to 10%, effective for tax years beginning after Dec. 31, 2012. The AGI floor for individuals age 65 and older (and their spouses) will remain unchanged at 7.5% through 2016.

Limit reimbursement of over-the-counter medications from HSAs, FSAs, and MSAs. The new law excludes the costs for over-the-counter drugs not prescribed by a doctor from being reimbursed through a health reimbursement account (HRA) or health flexible savings accounts (FSAs) and from being reimbursed on a tax-free basis through a health savings account (HSA) or Archer Medical Savings Account (MSA), effective for tax years beginning after Dec. 31, 2010.

Increased penalties on nonqualified distributions from HSAs and Archer MSAs. The new law 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 from 15% for Archer MSAs) of the disbursed amount, effective for distributions made after Dec. 31, 2010.

Limit health flexible spending arrangements (FSAs) to \$2,500. An FSA 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 as established in the cafeteria plan, most commonly for medical expenses but often for dependent care or other expenses. Under current law, there is no limit on the amount of contributions to an FSA. Under the new law, however, allowable contributions to health FSAs will be capped at \$2,500 per year, effective for tax years beginning after Dec. 31, 2012. The dollar amount will be indexed for inflation after 2013.

Dependent coverage in employer health plans. Effective on the enactment date, the new law extends the general exclusion for reimbursements for medical care expenses under an employer-provided accident or health plan to any child of an employee who has not attained age 27 as of the end of the tax year. This change is also intended to apply to the exclusion for employer-provided coverage under an accident or health plan for injuries or sickness for such a child. A parallel change is made for VEBA and 401(h) accounts. Also, self-employed individuals are permitted to take a deduction for the health insurance costs of any child of the taxpayer who has not attained age 27 as of the end of the tax year.

Excise tax on indoor tanning services. The new law 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 July 1, 2010.

Liberalized adoption credit and adoption assistance rules. For tax years beginning after Dec. 31, 2009, the adoption tax credit is increased by \$1,000, made refundable, and extended through 2011. The adoption assistance exclusion is also increased by \$1,000.

(Small Business)

Tax credits to certain small employers that provide insurance. The new law provides small employers with a tax credit (i.e., a dollar-for-dollar reduction in tax) for nonelective contributions to purchase health insurance for their employees. The credit can offset an employer's regular tax or its alternative minimum tax (AMT) liability.

Small business employers eligible for the credit. To qualify, a business must offer health insurance to its employees as part of their compensation and contribute at least half the total premium cost. The business must have no more than 25 full-time equivalent employees ("FTEs"), and the employees must have annual full-time equivalent wages that average no more than \$50,000. However, the full amount of the credit is available only to an employer with 10 or fewer FTEs and whose employees have average annual full-time equivalent wages from the employer of less than \$25,000.

Years the credit is available. The credit is initially available for any tax year beginning in 2010, 2011, 2012, or 2013. Qualifying health insurance for claiming the credit for this first phase of the credit is health insurance coverage purchased from an insurance company licensed under state law. For tax years beginning after 2013, the credit is only available to an eligible small employer that purchases health insurance coverage for its employees through a state exchange and is only available for two years. The maximum two-year coverage period does not take into account any tax years beginning in years before 2014. Thus, an eligible small employer could potentially qualify for this credit for six tax years, four years under the first phase, and two years under the second phase.

Calculating the amount of the credit. For tax years beginning in 2010, 2011, 2012, or 2013, the credit is generally 35% (50% for tax years beginning after 2013) of the employer's nonelective contributions toward the employees' health insurance premiums. The credit phases out as firm-size and average wages increase. Tax-exempt small businesses meeting these requirements are eligible for payroll tax credits of up to 25% for tax years beginning in 2010, 2011, 2012, or 2013 (35% in tax years beginning after 2013) of the employer's nonelective contributions toward the employees' health insurance premiums.

Special rules. The employer is entitled to an ordinary and necessary business expense deduction equal to the amount of the employer contribution minus the dollar amount of the credit. For example, if an eligible small employer pays 100% of the cost of its employees' health insurance coverage and the amount of the tax credit is 50% of that cost (i.e., in tax years beginning after 2013), the employer can claim a deduction for the other 50% of the premium cost.

Self-employed individuals, including partners and sole proprietors, two percent shareholders of an S corporation, and five percent owners of the employer are not treated as employees for purposes of this credit. Any employee with respect to a self-employed individual is not an employee of the employer for purposes of this credit if the employee is not performing services in the trade or business of the employer. Thus, the credit is not available for a domestic employee of a sole proprietor of a business. There is also a special rule to prevent sole proprietorships from receiving the credit for the owner and their family members. Thus, no credit is available for any contribution to the purchase of health insurance for these individuals and the individual is not taken into account in determining the number of full-time equivalent employees or average full-time equivalent wages.

Most small businesses exempted from penalties for not offering coverage to their employees. Although the new law imposes penalties on certain businesses for not providing coverage to their employees (so-called "pay or play"), most small businesses won't have to worry about this provision because employers with fewer than 50 employees aren't subject to the "pay or play" penalty. For businesses with at least 50 employees, the possible penalties vary depending on whether or not the employer offers health insurance to its employees. If it does not offer coverage and it has at least one full-time employee who receives a premium tax credit, the business will be assessed a fee of \$2,000 per full-time employee, excluding the first 30 employees from the assessment. So, for example, an employer with 51 employees who doesn't offer health insurance to his employees will be subject to a penalty of \$42,000 (\$2,000 multiplied by 21). Employers with at least 50 employees that offer coverage but have at least one full-time employee receiving a premium tax credit will pay \$3,000 for each employee receiving a premium credit (capped at the amount of the penalty that the employer would have been assessed for a failure to provide coverage, or \$2,000 multiplied by the number of its full-time employees in excess of 30). These provisions take effect Jan. 1, 2014.

The "Cadillac tax" on high-cost health plans. The new law places an excise tax on high-cost employer-sponsored health coverage (often referred to as "Cadillac" health plans). This is a 40% excise tax on insurance companies, based on premiums that exceed certain amounts. The tax is not on employers themselves unless they are self-funded (this typically occurs at larger firms). However, it is expected that employers and workers will ultimately bear this tax in the form of higher premiums passed on by insurers.

Here are the specifics: The new tax, which applies for tax years beginning after Dec. 31, 2017, places a 40% nondeductible excise tax on insurance companies and plan administrators for any health coverage plan to the extent that the annual premium exceeds \$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. The tax will apply to self-insured plans and plans sold in the group market, but not to plans sold in the individual market (except for coverage eligible for the deduction for self-employed individuals). Stand-alone dental and vision plans will be disregarded in applying the tax. The dollar amount thresholds will be automatically increased if the inflation rate for group medical premiums between 2010 and 2018 is higher than the Congressional Budget Office (CBO) estimates in 2010. Employers with age and gender demographics that result in higher premiums could value the coverage provided to employees using the rates that would apply using a national risk pool. The excise tax will be levied at the insurer level. Employers will be required to aggregate the coverage subject to the limit and issue information returns for insurers indicating the amount subject to the excise tax.

HIRE ACT:

Extension of enhanced small business expensing (Section 179). The new law gives a one-year lease on life to enhanced expensing rules, which allow qualifying businesses the option to currently deduct the cost of business machinery and equipment, instead of recovering it via depreciation over a number of years. For tax years beginning in 2010, the maximum amount that a business may expense is \$250,000, and the expensing election begins to phase out when a business buys more than \$800,000 of expensing-eligible assets. These dollar limits are the same as those that were in effect for 2008 and 2009.

Payroll tax holiday and up-to-\$1,000 credit for employers who hire unemployed workers. To help stimulate the hiring of workers by the private sector, the new law exempts any private-sector employer that hires a worker who had been unemployed for at least 60 days from having to pay the employer's 6.2% share of the Social Security payroll tax on that employee for the remainder of 2010. A company could save a maximum of \$6,621 if it hired an unemployed worker and paid that worker at least \$106,800—the maximum amount of wages subject to Social Security taxes—by the end of the year. As an additional incentive, for any qualifying worker hired under this initiative that the employer keeps on payroll for a continuous 52 weeks, the employer is eligible for an additional non-refundable tax credit of up to \$1,000 after the 52-week threshold is reached, to be taken on their 2011 tax return. In order to be eligible, the employee's pay in the second 26-week period must be at least 80% of the pay in the first 26-week period.

Workers hired after the date of introduction of the legislation (Feb. 3, 2010) are eligible for the payroll tax forgiveness and the retention bonus, but only wages paid after the date of the new law's enactment receive the exemption for payroll taxes.

Here are some additional features of the new hiring incentive:

- The tax benefit of the new incentive is immediate. It puts money into a business' cash flow immediately, since the tax is simply not collected in the first place.
- The tax benefit generally applies only to private-sector employment, including nonprofit organizations—public sector jobs are generally not eligible for either benefit. However, employment by a public higher education institution would qualify.
- There is no minimum weekly number of hours that the new employee must work for the employer to be eligible, and there is no maximum on the dollar amount of payroll taxes per employer that may be forgiven.
- For workers that would otherwise be eligible for the "Work Opportunity Tax Credit," the employer must select one benefit or the other for 2010—no double dipping.
- An employer can't claim the new tax breaks for hiring family members.
- A worker who replaces another employee who performed the same job for the employer is not eligible for the benefit, unless the prior employee left the job voluntarily or for cause.
- For the hiring to qualify, the new hire must sign an affidavit, under penalties of perjury, stating that he or she has not been employed for more than 40 hours during the 60-day period ending on the date the employment begins.
- The incentive is not biased towards either low-wage or high-wage workers. Under the measure, a business saves 6.2% on both a \$40,000 worker and a \$90,000 worker.
- The payroll tax holiday does not apply with respect to wages paid during the first calendar quarter of 2010, but the amount by which the Social Security payroll tax would have been reduced under the payroll tax holiday provision during the first calendar quarter is applied against the tax imposed on the employer for the second calendar quarter of 2010.
- The Hire Act creates a similar new set of rules permitting a payroll tax holiday for railroad retirement tax purposes.
- The credit for retaining qualifying new hires is the lesser of \$1,000 or 6.2% of the wages paid by the taxpayer to the retained worker during the 52-consecutive-week period. Thus, the credit for a retained worker will be \$1,000 if, disregarding rounding, the retained worker's wages during the 52-consecutive-week period exceed \$16,129.03. However, the credit is not available for pay not treated as wages under the IRS Code (e.g., remuneration paid to domestic workers).

Direct payment option for certain tax credit bonds. State and local governments have the ability to issue special purpose tax credit bonds for school construction, energy conservation, and renewable energy. The federal government subsidizes these tax credit bonds by providing investors in these bonds with a federal tax credit in place of interest that would otherwise be payable on the bond. In lieu of providing investors with federal tax credits, the new law allows issuers of qualified school construction bonds, qualified zone academy bonds, clean renewable energy bonds, and qualified energy conservation bonds to elect to receive a direct payment from the federal government equal to the amount of the federal tax credit that would otherwise be provided for these bonds.

Please feel free to call us if you would like more details about these new provisions or any other aspect of the new law or visit our website at www.gccpas.net.

Sincerely,

A handwritten signature in black ink that reads "Grumbleby Coleman". The signature is written in a cursive, flowing style.

Grimbleby Coleman
Certified Public Accountants, Inc.

Time Line of Tax Provisions in the Health Care Reform Act	
Effective Date	Provision
2010	
After 12/31/2009 and before 1/1/2012	Adoption credit increased (to \$13,170 from \$12,170 in 2010), extended through 2011 and made refundable
After 12/31/2009	An insurance credit is allowed to small employers paying at least 50% of employee's health insurance costs. The average annual wages of employees must be under \$25,000. The credit is as high as 35% (50% after 2013)
For tax years after 12/31/2008	50% credit provided to small business for investments in certain qualifying therapeutic discovery projects for 2009 and 2010
After 3/30/2010	Income exclusion for employer provided health insurance extended to children under age 27
After 12/31/2009	Exclusion for employer provided adoption assistance increased by \$1,000
After 3/30/2009	Self-employed health insurance premium includes premiums paid by taxpayer for child under age 27
After 12/31/2009	Penalty increased to 20% for non qualified HSA and FSA distributions after 2010
Performed after 7/1/2010	10% excise tax on indoor tanning services
2011	
After 12/31/2010	FSA, HSA, HRA, and MSA qualified distributions include withdrawals for prescription drugs and insulin only, no over-the-counter drugs
After 12/31/2010	Establish simple cafeteria plans for small employers
After 12/31/2010	Cost of employer sponsored health coverage must be shown on W-2
2012	
After 12/31/2011	Information reporting required for payments of \$600 or more for property or services to a non tax exempt corporation
2013	
After 12/31/2012	Medical expense deduction increases to 10% after 2012, after 2017 for people 65 or older
After 12/31/2012	FSA contributions limited to \$2,500
After 12/31/2012	Medicare premium increases by 0.9% for taxpayers whose AGI exceeds \$200,000 single and \$250,000 MFJ
After 12/31/2012	Employee Medicare tax increases by 0.9% on wages over \$200,000 single (\$250,000 combined wages MFJ)
After 12/31/2012	New 3.8% Medicare tax assessed on net investment income of individuals, and estate and trusts with income over \$200,000 single and \$250,000 MFJ

2014	
After 12/31/2013	Individuals between 100% and 400% of federal poverty level will qualify for refundable tax credit (“premium assistance credit”) to offset exchange-purchased health insurance premiums
After 12/31/2013	Exclusion from income of free choice vouchers
After 12/31/2013	Deduction allowed to employer for free choice vouchers
After 12/31/2013	Employers with at least 50 full time employees may be subject to penalty if not providing health insurance coverage to employees
After 12/31/2013	“Shared responsibility penalty” assessed against taxpayers who do not have health coverage. Penalty is phased in over three years starting in 2014 at \$95 per individual (\$285 per family), in 2015 at \$325 per individual (\$975 per family) and in 2016 at \$695 per individual (\$2,085 per family)
After 12/31/2013	Reporting of employer health insurance coverage
2018	
After 12/31/2017	40% excise tax assessed against “Cadillac” employer sponsored health plans where premium exceeds \$10,200 for individual coverage and \$27,500 for family coverage