Anthony P. Curatola, Editor

Affordable Care Act and 2012 Tax Provisions

The Supreme Court issued a ruling upholding the constitutionality of the Affordable Care Act of 2010, which includes a number of tax provisions. Now taxpayers and employers must respond to the tax provisions that become effective in 2013 and beyond.

On June 28, 2012, the Supreme Court upheld the constitutionality of the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010. In a bit of a surprise, the Court didn't challenge the tax provisions in the legislation. As a result, taxpayers and employers need to prepare for tax law changes. Some provisions become effective in 2013, while others become effective in 2014 or later. This article looks at the new and amended tax provisions affecting individual taxpayers in 2013.

Itemized Medical Deduction

A taxpayer is able to deduct unreimbursed medical expenses if he or she satisfies two critical hurdles. First, the taxpayer must be able to file Schedule A claiming itemized deductions instead of electing the standard deduction. For 2009, less than 33% of all tax filers claimed itemized deductions. Second, a taxpayer can only deduct unreimbursed medical expenses in excess of 7.5% of his or her adjusted gross income (AGI). For 2009, approximately 7% (10.1 million returns) of all filers claimed the medical deduction. Of that group, approximately 90% had an AGI of $100,000 or less, according to Justin Brian in the Fall 2011 *Statistics of Income Bulletin*. In other words, the population of taxpayers currently claiming the medical deduction is quite small and includes mainly lower-income tax filers. Beginning in 2013, the second hurdle will increase from 7.5% to 10%, which will further decrease the number of taxpayers eligible to claim an itemized deduction for unreimbursed medical expenses.

A special exemption to the 10% hurdle is carved out for a select group of taxpayers. Specifically, the 7.5% hurdle is retained for those taxpayers or taxpayer spouses attaining age 65 before the close of taxable year 2017 (IRC §213(f)). The key word here is "or," which means only one spouse needs to reach 65 during these years to qualify both spouses filing a joint return. After 2016, the 10% hurdle applies to all taxpayers.

Flexible Spending Accounts

Many companies sponsor flexible spending accounts (FSAs) (IRC §125(i)) for their employees. Participating in an FSA allows an employee to contribute up to $5,000 of pre-taxed wages during the calendar year and draw from this account to pay unreimbursed medical expenses incurred by the taxpayer, including spouse and dependents. (An in-depth discussion on FSAs and the use-or-lose rule appeared in the September 2005 tax column.)

Beginning in 2013, the maximum contribution to an FSA will be reduced to $2,500 per year (adjusted for inflation in increments of $50 after 2013). The true impact of lowering the maximum contribution amount is speculative. For taxpayers contributing more than the new $2,500 limit, the reduced FSA more than likely will result in a tax increase. For those in the upper-income brackets, the reduced FSA will most likely not be deductible as an itemized medical deduction. For those in the lower tax brackets, the reduced FSA may result in an increase in or ability to claim an itemized medical deduction. In general, one would speculate that tax liabilities for all these itemizers will increase.

Additional 0.9% Medicare Tax

Currently, every wage earner pays a 1.45% hospital insurance (HI) tax on wages. Beginning in 2013, an additional 0.9% HI tax under IRC §3101(b)(2) is imposed on all taxpayers (other than a corporation, estate, or trust). The IRS posted a Q&A for this additional Medicare tax (www.irs.gov/businesses/small/article/0,,id=258201,00.html).

This tax gets complicated. To begin, an individual is liable for this additional tax if his or her wages, other compensation, and/or net self-employment income exceed $200,000. In the case of a married couple, the additional tax is based on the couple's income that exceeds $250,000 (or $125,000 if filing separately). This will necessitate advisors to inform clients of their potential need to file estimated taxes in 2013 or adjust their W-4 withholdings, especially if both spouses are employed or one spouse has more than one job. This tax is easily seen as another form of the marriage penalty (i.e., the threshold of $250,000 isn't twice that of $200,000). Likewise, employers will be required to withhold for the additional HI tax only after a taxpayer, regardless of tax filing status, earns more than $200,000. Married taxpayers earning more than $200,000 but less than $250,000 will seek a refund of the tax when filing their 2013 tax return.

Additional 3.8% Medicare Tax

If the additional 0.9% HI tax on earned income weren't enough, a new 3.8% HI tax is placed on net investment income. The additional 3.8% HI tax has the same threshold limits (i.e., $250,000 for married joint filers, $125,000 for married separate filers, and $200,000 for all others), which aren't indexed for inflation. But the calculation rule is different to allow the two additional taxes to work together. The 3.8% HI tax is the lesser of net investment income as provided in IRC §1411(c) or modified AGI (MAGI) as provided in IRC §1411(d). As a result, a taxpayer will be subject to the full 3.8% HI tax only if his or her MAGI exceeds the threshold limit for his or her tax filing status by the full net investment income amount.

Example 1: Taxpayer A has wages and net self-employment income of $180,000 and net investment income of $30,000. In Taxpayer A's case, there's no additional 0.9% HI tax because earned income doesn't exceed the $200,000 threshold amount. But the 3.8% HI tax does apply. Specifically, Taxpayer A owes an additional $380, which is the lesser of $1,140 (3.8% of $30,000) or $380 (3.8% of ($210,000 – $200,000).

Example 2: If Taxpayer A had wages of $220,000 instead of $180,000, the total additional HI tax would be $1,900. This amount is the sum of $760 (3.8% of ($220,000 – $200,000)) attributable to earned income and $1,140, which is the lesser of $1,140 (3.8% of $30,000) or $1,900 (3.8% of ($250,000 – $200,000).

There are some income items that aren't included in the 3.8% HI tax. For example, the gain excluded from the sale of a principal residence isn't included, but any gain that's included in gross income could trigger the 3.8% HI tax on the MAGI amount. Likewise, income from tax-exempt investments, such as municipal bonds, isn't subject to this tax. Income from deferred compensation accounts (i.e., pensions, IRAs, and Roth IRAs) also is excluded. Although the IRS issued a Q&A for the 0.9% HI tax area, it hasn't issued any as yet for the 3.8% HI tax.

Tax Planning

Once tax legislation is signed into law, the next step is to evaluate the legislation and then do some tax planning. This area is no different. Potential tax planning strategies include the typical moves such as investing more in retirement accounts and/or moving dividend- and interest-yielding investments to growth or tax-exempt investments. This is especially important when one considers that the 3.8% HI tax will be on top of the increased ordinary income tax applicable to investment and capital gain income if the Bush-era tax cuts aren't extended. Obviously, there are other strategies. For example, taxpayers may want to adjust their W-4 withholdings unless they are already filing estimated tax returns. In any event, 2013 looks to be another interesting year for taxpayers and tax advisors—and maybe even Congress, depending on the upcoming elections. **SF**

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