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Key Developments, Quarter 2 2013

Here is a summary of the important tax developments occurring in the past three months that may affect you, your family, your investments, and your livelihood. Please call us for more information about any of these developments and what steps you should implement to take advantage of favorable developments and to minimize the impact of those that are unfavorable.

Obamacare

Employer health care reporting and mandate payments postponed until 2015. On July 2, 2013, the Administration announced on the White House and Treasury websites that it will provide an additional year, until Jan. 1, 2015, before the mandatory employer and insurer reporting requirements under the Affordable Care Act (ACA, commonly referred to as "Obamacare") begin. Since this will make it impractical to determine which employers do not provide minimum essential health coverage, and therefore would owe shared responsibility payments under Code Sec. 4980H for 2014, transition relief is also being extended for those payments. Any employer shared responsibility payments will not apply until 2015.

The Congressional Research Service (CRS) has issued a report outlining the required functions of health insurance exchanges under the ACA. Under the ACA, qualified individuals and small businesses will be able to purchase private health insurance through exchanges set up by states or by the federal Health & Human Services Agency (HHS). The initial open enrollment period for all exchanges will begin on October 1, 2013, and all exchanges are to be operational and offering coverage on January 1, 2014. Exchanges must carry out a number of functions, including determining eligibility and enrolling individuals in appropriate plans. In general, health plans offered through exchanges will provide comprehensive coverage and meet the private market reforms specified in the ACA. To make exchange coverage more affordable, qualifying individuals will receive premium assistance in the form of tax credits. Some recipients of these premium credits also may qualify to receive subsidies to help cover their cost-sharing expenses. The CRS report provides a detailed explanation of these exchanges, coverage offered through them, and the cost assistance features mentioned above.

Guidance on health care premium tax credit. The IRS has issued proposed regulations on the health care premium tax credit, which applies for tax years ending after Dec. 31, 2013. The credit is designed to make health insurance affordable to individuals with modest incomes (i.e., between 100% and 400% of the federal poverty level, or FPL) who are not eligible for other qualifying coverage, such as Medicare, or "affordable" employer-sponsored health insurance plans that provide "minimum value." It is available for individuals who purchase affordable coverage through "Affordable Insurance Exchanges." In general, an employer-sponsored plan is not affordable if the employee's required contribution with respect to the plan exceeds 9.5% of his household income for the tax year. The proposed regulations address (i) minimum value, including the treatment of health reimbursement arrangements, health savings accounts, wellness program incentives, arrangements that reduce premiums, and methods for determining minimum value; (ii) the definition of "modified adjusted gross income" as it comes into play in determining household income for purposes of the credit; (iii) coverage for retirees, newborns and newly adopted children; and (iv) premium assistance amounts for partial months of coverage.

Guidance on required employer notice on health care coverage options. Beginning Jan. 1, 2014, individuals and employees of small businesses will have access to affordable health care coverage through a new competitive private health insurance market called the "Health Insurance Marketplace" (the Marketplace). Certain employers must provide written notice to employees about health insurance coverage options available through the Marketplace. A government agency has provided the following guidance on the notice requirement and has issued model notices:

1. *Who must provide notices.* Notices must be provided by any employers to whom the Fair Labor Standards Act applies. Generally, this means an employer that employs one or more employees who are engaged in, or produce goods for, interstate commerce. For most firms, this rule doesn't apply if they have less than $500,000 in annual dollar volume of business.
2. *To whom must notices be provided.* Employers must provide a notice to each employee, regardless of plan enrollment status (if applicable), or of part-time or full-time status. Employers do not have to provide a separate notice to dependents or other individuals who are, or may become, eligible for coverage under any available plan, but who are not employees.
3. *Form and content of notice.* The notice must be provided in writing in a manner calculated to be understood by the average employee. The notice must include information regarding the existence of a new Marketplace, as well as contact information and a description of the services provided by the Marketplace. In addition, the notice must: (1) inform the employee that the employee may be eligible for a premium tax credit if the employee purchases a qualified health plan (QHP) through the Marketplace, and (2) include a statement informing the employee that if the employee purchases a QHP, the employee may lose the employer contribution (if any) to any health benefits plan offered by the employer, and that all or a portion of such contribution may be excludable from income for federal income tax purposes.
4. *Timing and delivery of notice.* Employers must provide the notice to each new employee at the time of hiring *beginning Oct. 1, 2013.* For 2014, a notice is considered to be provided at the time of hiring if it is provided within 14 days of an employee's start date. For employees who are current employees before Oct. 1, 2013, employers must provide the notice no later than *Oct 1, 2013.*

Final regulations on wellness incentives in group health plans*.* The IRS, acting in concert with other government agencies, has issued final regulations on nondiscriminatory wellness incentives offered in connection with group health plans. Before Obamacare, group health plans and group health issuers were prohibited from discriminating against individual participants and beneficiaries regarding eligibility, benefits and premiums, based on a health factor. However, an exception allowed premium discounts or rebates or modifications to otherwise applicable cost sharing in return for adherence to certain programs of health promotion and disease prevention. The exception allowed benefits, premiums, and contributions to vary depending on the employees' participation in a wellness program. Obamacare made changes to the rules impacting wellness programs, most notably increasing the maximum financial incentives available to employees who participate in wellness programs. The new regulations provide numerous examples of participatory wellness programs, including a program that reimburses employees for all or part of the cost of membership in a fitness center; a diagnostic testing program that provides a reward for participation and does not base any part of the reward on outcomes; and a program that provides a reward to employees for attending monthly, no-cost health education seminars. They also clarify that participatory wellness programs are permissible as long as they are available to all similarly situated individuals, regardless of health status.

Final regulations fill in statutory gaps on indoor tanning tax*.* The IRS has issued final regulations on the health reform legislation's 10% excise tax on indoor tanning services provided on or after July 1, 2010. The regulations address practical considerations that may not have been contemplated when the law was drafted. For example, they address prepayments for tanning services and services provided as part of a gym membership. The IRS had previously issued the regulations as temporary regulations. The final regulations adopted the temporary ones with some clarifications.

Retirement Accounts

Individuals' guarantees of loan to company owned by their IRAs were prohibited transactions. The Tax Court has held that taxpayers' guarantees of loans to a company, the stock of which was held by their individual retirement accounts (IRAs), to purchase another company's assets, were prohibited transactions under the tax laws. As a result, their accounts ceased to be tax-exempt IRAs, and the taxpayers were liable for tax on the capital gains realized on the later sale of the company stock. The individuals argued their personal guarantees weren't prohibited transactions because they covered loans to an entity owned by the IRAs, rather than a loan to the IRAs themselves. However, the

Tax Court found that each of the individuals' personal guarantees of the company loan was an indirect extension of credit to the IRAs, which is a prohibited transaction.

Sixty-day rollover rule waived for individual with medical impairments. There is no immediate tax if distributions from traditional IRAs are rolled over to an IRA or other eligible retirement plan within 60 days of receipt of the distribution. A distribution rolled over after the 60-day period generally will be taxed (and also may be subject to a 10% premature withdrawal penalty tax). However, the IRS may waive the 60-day rule if an individual suffers a casualty, disaster, or other event beyond his reasonable control, and not waiving the 60-day rule would be against equity or good conscience (i.e., hardship waiver). In a recent private letter ruling, the IRS waived the 60-day rollover requirement for a taxpayer who withdrew funds from her IRA and failed to timely roll them over due to medical conditions that impaired her ability to manage her financial affairs.

Taxpayer could undo mistaken Roth IRA conversion. Taxpayers, including married persons filing separately, may convert amounts in a traditional IRA to a Roth IRA, but the conversion is taxable. If the taxpayer had basis in the IRA-i.e., he had made nondeductible contributions to the IRA-the conversion would be includible in gross income only to the extent that the converted amount exceeded his basis. A recharacterization election allows a taxpayer to treat a traditional-IRA-to-Roth-IRA conversion as if it had never been made. This is sometimes done where the value of the assets in the account dropped significantly after the conversion. Normally, a recharacterization must be done not later than Oct. 15 of the year after the year of the conversion. But a taxpayer was able to undo a conversion beyond this deadline where his attorney mistakenly told him he had a large basis (and thus a small taxable amount) when in fact he had a zero basis. The attorney confused the cost of the securities in the account with the taxpayer's basis in the IRA. The taxpayer got relief from the IRS after seeking it in a private letter ruling.

Payroll Taxes

Additional Medicare tax may warrant withholding or estimated tax adjustments. Individuals with high earned income from wages or self-employment should consider whether they need to adjust their withholding allowances and/or estimated tax to take into account the additional 0.9% Medicare tax that applies for the first time this year.

Effective for tax years beginning after 2012, an additional 0.9% Medicare (hospital insurance, or HI) tax applies to individuals receiving wages with respect to employment in excess of $200,000 ($250,000 for married couples filing jointly and $125,000 for married couples filing separately). The tax is in addition to the regular Medicare rate of 1.45% on wages received by employees. The tax only applies to the employee portion of the Medicare tax. The employer Medicare tax rate remains at 1.45%, and the employer and employee Social Security tax remain at 6.2% on the first $113,700 of wages.

The Medicare tax on self-employment income for any tax year beginning after Dec. 31, 2012, also is increased by an additional 0.9% of self-employment income that exceeds the same thresholds as apply for employees (see above). But the $200,000, $250,000, and $125,000 thresholds are reduced by any wages taken into account in determining the additional 0.9% HI tax on wages.

In the case of employees, the additional 0.9% Medicare tax is collected through withholding on FICA wages (or Railroad Retirement Tax Act (RRTA) compensation) in excess of $200,000 in a calendar year. In addition, employees may request additional income tax withholding (ITW) on wages on Form W-4, and use this additional ITW to apply against taxes shown on their return, including any additional 0.9% Medicare tax liability. To the extent not withheld, the 0.9% additional Medicare tax must be included when making estimated tax payments.

Employers must withhold the additional Medicare tax from wages in excess of $200,000 regardless of filing status or other income. The additional withholding applies in the pay period in which the employer pays wages in excess of $200,000 to an employee, and the employer need not notify the employee that additional withholding has commenced.

Some taxpayers should consider having more income tax withheld if they have not had enough Medicare tax withheld. Keep in mind that the additional 0.9% Medicare tax will not be withheld by an employer unless the employee has received more than $200,000 of wages from that company. Thus, an employee who begins working for a new employer midway through the year, and who expects to exceed the $200,000 threshold only after taking into account wages from all employers during 2013, could wind up having too little withheld.

An employer must begin withholding the additional Medicare tax once an employee's wages are over the threshold, even if the employee may not ultimately be liable for this tax. This could occur, for example, if one spouse earns $250,000, the other spouse isn't employed, and they file a joint return. Although the employer must withhold on the employed spouse's wages to the extent they exceed $200,000, the couple wouldn't actually be liable for the additional Medicare tax because their wages won't exceed the applicable $250,000 threshold. Thus, at year-end, the couple will wind up having overpaid $450 in Medicare tax (.9% of $50,000). This couple can adjust their W-4 withholding downward to account for the excess $450 withheld for Medicare tax.

Home and Investments

Couple couldn't deduct mortgage interest added to principal. In a recent case involving a negative amortization loan, a couple was denied a mortgage interest deduction for the unpaid interest that was added to principal. Since they reported their taxes using the cash method of accounting, the couple couldn't deduct this interest because they did not pay it. The IRS also wanted to impose a penalty on them, but the Tax Court refused to do so. It found that the husband credibly testified that he reported the interest deduction using what he thought was stated on the Form 1098, Mortgage Interest Statement, received form the lender.

Final regulations implement broker reporting of debt instruments & options in phases. The IRS has issued final regulations on the reporting of debt instruments and options by brokers and others under various provisions of the Internal Revenue Code. Recognizing that the proper implementation of broker basis reporting for debt instruments will require time to build and implement reporting systems, especially for debt instruments with more complex features, the final regulations implement basis reporting for debt instruments in phases to promote an orderly transition to the new rules. Under the regulations, when reporting the sale of securities to the IRS, brokers must include the customer's adjusted basis in the sold securities and classify any capital gain or loss as long-term or short-term. The regulations also implement reporting requirements for gross proceeds from a sale or closing transaction with respect to certain options, for a transfer of a debt instrument or an option to another broker, and for an organizational action that affects the basis of a debt instrument or an option.

Temporary regulations on reporting of bond and acquisition premium. Under the tax laws, amortized bond premium offsets stated interest payments. As a result, only the portion of a stated interest payment that is not offset by the amortized premium is treated as interest for federal income tax purposes. To improve consistency between income reporting and basis reporting and to provide immediate guidance to brokers and investors, the IRS has issued temporary regulations that require broker reporting of original issue discount income to reflect amounts of amortized bond premium or acquisition premium for a covered debt instrument.

Partner couldn't report sale of unrealized receivables under the installment method. The Tax Court has held that an individual couldn't use the installment method to report the portion of the proceeds from the sale of her partnership interest that was attributable to the partnership's unrealized receivables. Income from an installment sale is taken into account under the installment method; that is, a portion of the total gross profit from an installment sale is included in income in each year in which the seller receives payment. The amount received by a transferor partner in exchange for the part of his partnership interest attributable to unrealized receivables of the partnership is treated as an amount realized from the sale or exchange of property other than a capital asset.

In a recent case, a taxpayer sold her interest in a partnership that had unrealized receivables and reported the sale on the installment method. She reported the gain over the years as capital gain, which is taxed at lower rate than ordinary income. The IRS went after her, and the Tax Court held that she couldn't use the installment method for the portion of the gain allocable to the unrealized receivables. Rather, this portion of the gain had to be reported in the year of the sale and as ordinary income. The Court did allow her to reduce the amount she had reported as capital gain by the amount she had to report as ordinary income.

Impact of Inflation on Taxes

Official explains impact of chained CPI on social security and taxes. A government official explained how using chained consumer price index (CPI) for benefit programs and the tax Code would affect taxpayers, social security recipients, and government revenues. In general, chained CPI grows at a slower pace than standard CPI by fully accounting for a consumer's ability to substitute between goods in response to changes in relative prices. A switch to chained CPI would result in smaller annual cost-of living-adjustments for social security benefits and would affect a number of inflation-adjusted tax provisions. These items include the personal exemption, the standard deduction, and the income thresholds for the individual income tax brackets and for numerous other deductions, exclusions, and tax credits. If the change to chained CPI goes through, annual increases to these various tax-related amounts would be lower than under the current standard CPI for providing inflation adjustments. As a result, the government would pay out less benefits and take in more revenue if chained CPI is implemented.

Next year's inflation adjustments for health savings accounts. The IRS has provided the annual inflation-adjusted contribution, deductible, and out-of-pocket expense limits for 2014 for health savings accounts (HSAs). Eligible individuals may, subject to statutory limits, make deductible contributions to an HSA. Employers as well as other persons (e.g., family members) also may contribute on behalf of an eligible individual. Employer contributions generally are treated as employer-provided coverage for medical expenses under an accident or health plan and are excludable from income. In general, a person is an "eligible individual" if he is covered under a high deductible health plan (HDHP) and is not covered under any other health plan that is not a high deductible plan, unless the other coverage is permitted insurance (e.g., for worker's compensation, a specified disease or illness, or providing a fixed payment for hospitalization). For calendar year 2014, the limitation on deductions is $3,300 (up from $3,250 for 2013) for an individual with self-only coverage. It's $6,550 (up from $6,450 for 2013) for an individual with family coverage under a HDHP. Each of these amounts is increased by $1,000 if the eligible individual is age 55 or older.

Maximum auto/truck values for cents-per-mile valuation. The IRS has released the 2013 maximum fair market values for employer-provided autos, trucks and vans, the personal use of which can be valued for fringe benefit purposes at the mileage allowance rate. An employer must treat an employee's personal use of an employer-provided auto as fringe benefit income and value it using one of several methods. One of the permitted methods allows an employer to value personal use at the mileage allowance rate (56.5¢ per mile for 2013). However, this method may be used only if the auto's fair market value does not exceed $12,800, as adjusted for inflation. The inflation-adjusted figures for vehicles first made available to employees for personal use in 2013 are $16,000 for autos (up from $15,900 for 2012) and $17,000 for trucks and vans (up from $16,700 for 2012).

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