Advanced Strategies

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HEALTH CARE LEGISLATION

In late March, President Obama signed into law the largest piece of health care reform legislation in the history of the United States. This legislation came in two parts: The Patient Protection and Affordable Care Act (PPACA) and The Health Care and Education Tax Credits Reconciliation Act of 2010 (HCETCRA 2010). In addition to new health care and health insurance rules, these two pieces of legislation contain numerous tax and tax-like provisions that will affect a wide variety of people and entities, including small businesses, high-income individuals, low-income individuals, health-care plans, and non-profit hospitals.

Under the health care legislation there is a new Medicare tax on high-income taxpayers that goes into effect for tax years beginning after 2012. For most taxpayers it will affect income earned in 2013 and thereafter. This new tax is a 3.8% tax that is imposed on the lesser of (1) the individual's net investment income or (2) the excess of the modified adjusted gross income over a "threshold amount." The threshold amount is $250,000 for married couples filing jointly and $200,000 for single taxpayers. Based on this formula, if there is no investment income or the taxpayer's income is less than the threshold amount then the taxpayer will not be subject to this tax.

This new 3.8% tax will also apply to trusts and estates. The tax on trusts and estates is imposed on the lesser of: (1) undistributed net investment income, or (2) the excess of (a) the trust's adjusted gross income for the year over (b) the dollar amount for which the highest tax bracket begins.

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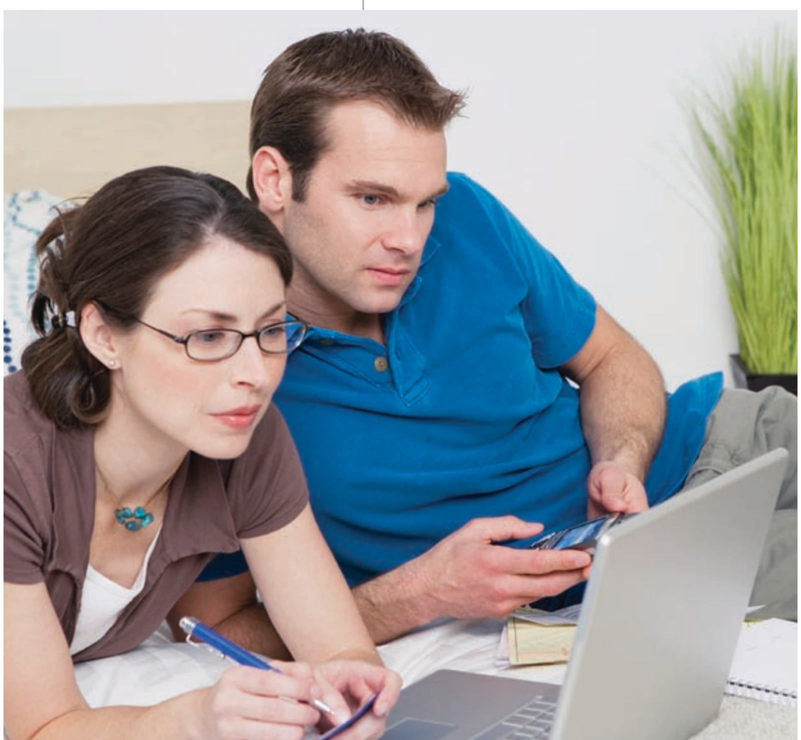
Again, if a trust or estate does not have undistributed investment income or if it has income that is less than the highest tax bracket (the highest trust income tax bracket in 2010 begins at only $11,200 of income) the trust or estate will not be subject to this tax.

For the purpose of this new tax, net investment income is the sum of gross income from: (1) interest, dividends, annuities, royalties, and rents; (2) a trade or business involving passive activities; and (3) net gain from dispositions of certain kinds of property. There are deductions allowed from the investment income for deductions that are allocated to that income. Also, net investment income does not include any item that is taken into account when determining a person's self-employment income.



It is not clear yet whether this additional tax would apply to surrenders from life insurance contracts. However, it is clear from the language of the new law that for the tax to apply there must be income. So the deferred inside buildup of annuities and life insurance would not be subject to the new tax. Also, annuities and life insurance can hold assets that are not accessed until later in life when income may be lower. Remember that the tax applies only to married couples earning greater than $250,000. So if your income in your retirement years is less than the threshold amount, you will not be subject to this new tax.

There is also an increased Medicare payroll tax for high income taxpayers. The Medicare tax is increased from 1.45% to 2.35% for taxpayers with wages and self-employment income above certain income thresholds (again $250,000 for married couples filing jointly and $200,000 for single taxpayers). Note that the deduction for one-half of an individual's self-employment tax is not allowed for this additional tax. This additional payroll tax is also in effect for tax years after 2012.

The health care legislation also included a requirement that all individuals who are not covered by Medicare or Medicaid must maintain a minimum health insurance plan or pay a penalty. This provision is in effect for January 2014. The law applies to any individual who does not fall into an exempt category. The exempt categories include religious exemptions, health care sharing ministries, individuals not lawfully in the United States, incarcerated individuals, and certain low-income individuals who cannot afford coverage.

Minimum coverage would mean enrollment in one of the following: (1) a government sponsored program (such as Medicare, Medicaid, the Children's Health Insurance Program, or the Veterans' Administration); (2) an employer sponsored plan; (3) a plan in the individual market; or (4) a grandfathered health plan. The penalty is applied to each person in a household who does not have the required minimum coverage, up to a maximum amount for each household. The maximum household penalty in 2014 will be $285 and will rise to $2,085 in 2016. After 2016, this maximum penalty amount will be indexed for inflation.

For tax years beginning after 2012 (2013 and after for most taxpayers) the threshold for deducting medical expenses is raised from 7.5% of adjusted gross income to 10%. The effective date for this rule is delayed until 2017 if the taxpayer reaches age 65 before the end of a particular tax year before 2017.

The health care legislation also limits the use of flexible spending accounts (FSAs). For tax years beginning after 2012, there is a limit on the amount that taxpayers can contribute to an FSA. For 2013, the limit is $2,500. For years after 2013, this amount will be indexed for inflation. The additional tax on non-qualified distributions from a health savings account (HSA) and Archer medical savings account (MSA) is increased to 20%. And for 2011 and thereafter, FSA, HSA, and MSA funds may not be used to purchase over-the-counter medication.

DRAFTING ERROR LEADS TO LOSS OF CHARITABLE DEDUCTION

A recent ruling by the Internal Revenue Service (IRS) highlights the importance of making sure a will has all the provisions in it that you want. The lack of specific language in a will providing funds to a charitable trust can cause the estate to lose its charitable deduction for funds that are eventually paid to that trust, as in the case below.

A father had executed a will before his death. The father also established a charitable trust before his death in a separate document. As part of the will, the father left a parcel of real estate in a trust to benefit his son and his son's wife. The father also provided that a certain amount of cash would be paid to the trust. The trustee of the trust holding the real estate is required to pay income from the trust to the son for the rest of the son's life. Then, upon the death of both his son and his son's wife, the trustee of the trust would need to sell the real estate and pay the proceeds from the sale, as well as other cash, to the charitable trust.

Other relatives of the father were the beneficiaries of similar trusts, with the relatives receiving payments for life and then the assets of the trust going to the charitable trust upon the relatives' deaths.

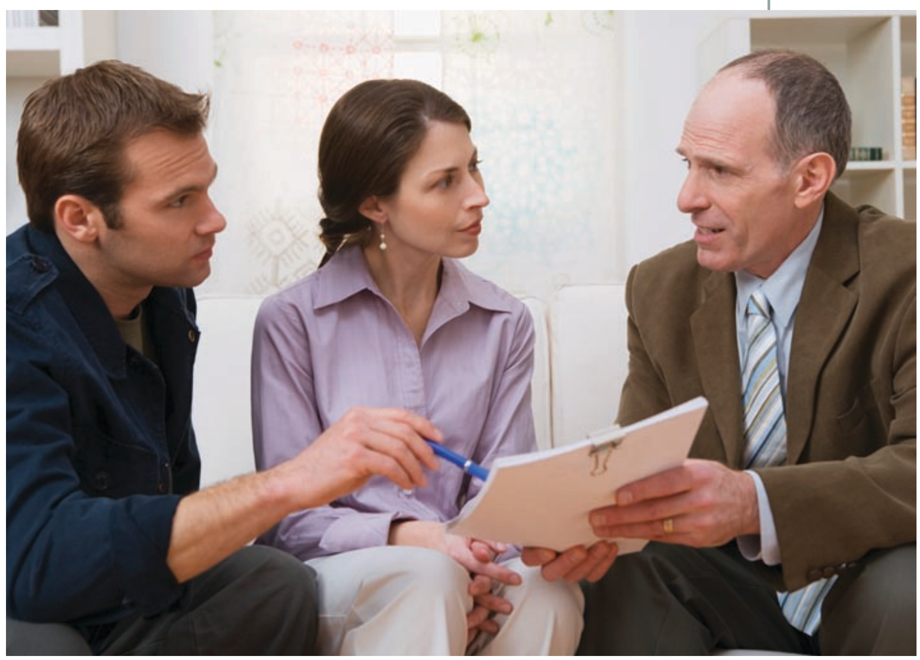
The father's will also said that expenses, debts, and taxes would be paid out of the residue of his estate, but did not say who would get the rest of the estate. The will also provided that if anyone sued to contest the will, that person would be considered to have died before the father and therefore take nothing, with that person's share going to the charitable trust.

The son was the father's only child, and he claimed that because he would inherit from his father if his father had not written a will, he should be entitled to the rest of his father's estate. The charitable trust claimed that the omitted residuary clause was due to an error by the drafter of the will. This position was supported by the father's attorney as well as other evidence which showed that the father intended to leave the rest of his estate to the charitable trust. This evidence included previously written wills that had the father leaving the rest of his estate to the charitable trust. The father also had a history of making a large number of lifetime charitable gifts.

After several months of talks, the son and charitable trust settled their dispute. There was a cash settlement paid to the son, and the rest of the estate was paid to the charitable trust.

The question was whether the estate was entitled to a charitable deduction for the amount that was paid to the charitable trust.

The IRS ruled that the estate would not be entitled to a charitable deduction. The ruling was based on the rules that say that a deduction for property passing to a spouse or charity will be allowed if the spouse or charity has an enforceable right under the particular law of the state. In this situation, it was not state law that required the payment to a charity, but a settlement between a charitable trust and a beneficiary to the deceased. Since there was nothing in the deceased father's will providing for the gift to the charitable trust, there cannot be any deduction for amounts that pass to the charitable trust.



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