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Tax Alert: Spring 2010

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SIGNIFICANT TAX CHANGES INCLUDED IN HEALTH CARE REFORM BILL

On March 21, the House passed the Patient Protection and Affordable Care Act (H.R. 3590) by a vote of 219-212. The bill was originally passed by the Senate on Dec. 24, 2009. President Obama signed the bill into law on March 23, 2010. The House also passed the Health Care and Education Affordability Reconciliation Act (H.R. 4872), which modifies key provisions of H.R. 3590, by a vote of 220-211. H.R. 4872 modifies H.R. 3590 by raising additional revenues from high-income households and reducing the impact that new excise taxes on high-cost health insurance policies will have on middle-class households.

Together, the bills will significantly change the nation's health care system and will cost $940B. To pay for these changes, the bills impose $438B in new taxes and fees on insurers, businesses, and individuals. The remainder of the cost is paid for by cuts in Medicare funding. According to the Congressional Budget Office (CBO), the bills are expected to reduce federal deficits by $143B over the next 10 years. The bills are also expected to expand health insurance coverage to 32 million individuals.

Major Tax Changes to Fund Healthcare Legislation

The bills significantly increase taxes on individuals with higher incomes and those that have more costly health insurance plans. Taxes include:

- A new 3.8 percent "Medicare contribution" tax on unearned income beginning in 2013 for individuals earning more than $200,000 per year ($250,000 for joint filers). Unearned income is passive income that a taxpayer receives on investments and includes interest, dividends, royalty income, rental income, gross income from a trade or business involving passive activities, and net gain from the disposition of property (other than property held in a trade or business). The amount of income subject to the tax is adjusted for any properly allowable deductions related **to that income. This provision significantly broadens the Medicare tax base. Importantly, the earning amounts are not indexed for inflation so the tax will apply to more taxpayers each year.**

- A new 0.9 percent surtax on individuals earning more than $200,000 per year ($250,000 for joint filers) on their share of their Hospital Insurance (HI) payroll taxes. **Like the Medicare contribution tax, the earnings amounts are not indexed.** Together, these two provisions are expected to raise $210B from 2013 until 2019.

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- A new 40 percent nondeductible excise tax on individuals with plans costing more than $8,500 ($23,000 for families), which is adjusted for inflation. The threshold increases to $9,850 ($26,000 for families) for individuals with certain high-risk jobs or those older than 55 but not yet receiving Medicare. H.R. 4872 delays the start date of these taxes from 2013 until 2018. H.R. 4872 also raises the threshold for taxation to $10,200 for individuals ($27,500 for families). H.R. 4872 includes a less generous inflation index than H.R. 3590. Both bills index the thresholds to the rate of the consumer price index for all urban consumers plus 1 percentage point, but the indexing in H.R. 4872 doesn't start until 2019, making it more likely that health insurance plans would be affected by the tax if health costs rise faster than overall inflation. Under H.R. 4872, the threshold levels are adjusted for plans that are priced higher because of the age and gender of employees. The bill also excludes the value of dental and vision benefits from the thresholds.

The bills provide tax credits for some individuals and small businesses in order to achieve coverage, including:

- A new credit for small businesses with up to 25 employees and average annual wages of less than $40,000. The credit, which is based on a sliding scale, will reimburse employers for up to 50 percent of the cost of providing insurance for their employees. For employers with fewer than 10 employees and average wages of less than $20,000, a 100 percent credit is available.

- A new credit for businesses equal to 50 percent of investments made in 2009 and 2010 for new therapies to prevent, diagnose, and treat acute and chronic diseases. An eligible taxpayer is a small business which may not employ more than 250 employees at the time of the submission of the application. The qualified investment is the aggregate amount of the costs paid or incurred for expenses necessary for and directly related to the conduct of the qualified project.

- A new premium assistance tax credit for individuals earning less than 400 percent of the federal poverty level. The credit, which is based on a sliding scale, will reimburse individuals for the cost of higher insurance premiums. The scale starts at 2 percent of income for those at 133 percent of the poverty level and phases out at 9.8 percent of income for those at 300-400 percent of the poverty level. The bill also expands Medicaid to individuals below 133 percent of the poverty level.

- An increase in the tax credit for adoptions from $10,000 to $13,170. The bills make the adoption tax credit adjusted to inflation, refundable, and available through 2011.

The bills impose penalties on individuals and employers for failing to obtain or provide coverage. These penalties also act as revenue raisers. The penalties include:

- Under H.R. 3590, a $750 penalty on employers per full time worker not covered if the employer has 50 employees and at least one of their employees qualifies for a premium subsidy in the exchange. H.R 4872 increases the penalty to $2,000 but exempts the first 30 employees from the penalty calculation.

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- Under H.R. 3590, a penalty on individuals who fail to obtain coverage. The penalty is equal to the greater of a flat fee or a percentage of income. The flat fee is equal to $95 in 2014, $495 in 2015, and $750 in 2016 and beyond. H.R. 4872 exempts individuals with incomes below the income tax filing threshold from the penalty and lowers the penalty amount to $325 in 2015 and $695 in 2016. The percentage of income is equal to 0.5 percent in 2014, 1 percent in 2015, and 2 percent in 2016 and beyond. H.R. 4872 increases those percentages to 1 percent in 2014, 2 percent in 2015, and 2.5 percent in 2016 and beyond. These changes provide relief to low- and middle-income individuals while increasing the burden on higher-income individuals.

The bills place new limitations on all individuals, including:

- A new $2,500 limit on tax-free contributions to health care flexible spending accounts.

- An increase in the penalty for nonqualified withdrawals from health savings accounts to 20 percent.

- A new prohibition to use Flexible Spending Account funds to purchase nonprescription medications.

- An increase in the threshold for claiming deductions for medical expenses to 10 percent of a taxpayer's adjusted gross income for those under 65, up from 7.5 percent.

The bills also include a number of new taxes and fees for businesses, including:

- A new 10 percent excise tax on indoor tanning services starting on July 1, 2010. This tax replaced a proposed tax on cosmetic surgery.

- A new excise tax on otherwise taxable medical device sales equal to 2.3 percent of the price of the device. A taxable medical device is any device defined in section 201(h) of the Federal Food, Drug, and Cosmetic Act and is intended for humans. This excise tax replaces an earlier proposed fee. Medical devices routinely purchased by consumers (as determined by the IRS) such as eyeglasses and hearing aids, are exempt from the tax.

- A new annual nondeductible fee on health insurance providers beginning in 2014. The fee would be allocated based on market share of net premiums written for U.S. health risks. The schedule for the flat fee would be: 2014, $8 billion; 2015 and 2016, $11.5 billion; 2017, $13.5 billion; 2018, $14.3 billion and indexed to medical inflation for later years. The fee would not apply to companies with net premiums written of $25 million or less. Qualified nonprofit insurance providers serving lower-income and other targeted groups are exempt from the fees as are certain voluntary employee benefit associations.

- A new nondeductible annual fee on pharmaceutical manufacturers and importers of branded drugs beginning in 2011. The fee will be allocated across the industry according to market share. The schedule for the flat fee would be: 2011, $2.5 billion; 2012 to 2016, $3 billion; 2017, $4 billion; 2018, $4.1 billion; 2019 and later, $2.8 billion. The fee would not apply to companies with sales of branded pharmaceuticals of $5 million or less.

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- A new requirement that 501(c)(3) hospitals conduct periodic community health needs assessments and adopt written financial assistance policies. Individuals that qualify for assistance will be billed at the same rates as insured individuals. The IRS will have to review these hospital's community benefit activities every three years.

- A modification of IRC section 162(m) as it applies to remuneration paid by health insurance providers to high-level executives. If at least 25 percent of the premium income to the insurer does not meet minimum essential coverage requirements under the bills, no 162(m) deduction would be allowed to the extent the remuneration exceeds $500,000.

The bills also include revenue raisers that have been present in various pieces of tax legislation considered by the Congress, including:

- Codifying the common-law economic substance doctrine and imposing significant penalties on taxpayers entering into transactions that lack economic substance. Under the economic substance doctrine, courts must tax benefits to taxpayers that enter into transactions that lack economic substance. The bill resolves a split in the various Circuit Courts of Appeal by clarifying that a transaction will be treated as having economic substance only if it changes the taxpayer's economic position in a meaningful way and has a substantial non-tax business purpose for the transaction. Courts are required to see if the transactions entered into by the taxpayer have the potential for profit. This provision includes a new strict liability penalty under section 6662 for an understatement of income and section 6676 for a claim for an excessive refund or credit due to a transaction undertaken by the taxpayer that lacks economic substance. The penalty rate is 20 percent (40 percent for a failure to adequately disclose all relevant facts). It is not yet clear what form the disclosure must take. There is no reasonable cause exception for public companies and any corporation with gross receipts in excess of $100M. The penalty provisions are expected to raise $4.5B in revenue through a combination of assessment, disclosure and the avoidance of taxpayers entering into transactions that lack substance. It is unclear how the penalty will be applied in practice and how aggressive field agents will be in seeking to apply the penalty, however, it is clear that once an IRS makes a determination that a transaction lacks economic substance, they are required to assess the penalty.

- Disallowing the use of the cellulosic biofuel producer credit for paper manufacturers that use a fuel known as "black liquor" to power their plants. Black liquor is a byproduct of paper pulp that has been used as a fuel since the 1930. This provision is expected to raise $23.6B.

Summary

The Patient Protection Act and the House Reconciliation Act will fundamentally alter the health care system for individuals and employers. The bills push the U.S. closer to universal coverage by requiring all individuals not covered by Medicaid or Medicare to obtain health care coverage or pay penalties. Employers electing not to offer qualifying coverage would be subject to penalties. Certain small businesses are exempted. In order to help individuals and small business pay for these new requirements, the bill offers tax credits to cover premiums. The costs of increased coverage will be paid for by a series of new taxes and fees on individuals and business. Higher income individuals will be subject to increased payroll taxes and new taxes on passive income. Individuals with expensive health care plans will be

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required to pay a significant excise tax. Businesses in various industries will be subject to fees. The bill also pays for its provisions by making cuts in Medicare and Medicaid funding to states. It appears that Congress will take up legislation to restore these cuts by enacting the so-called "doc-fixes" that were debated as part of the current bills. If it passes, the "doc fix" bill, which is expected to cost $371B, will restore much of the lost funding in the form of payments to doctors that accept Medicare and Medicaid. Additional changes to the current bills are likely to be passed in the coming months.

HIRE ACT OFFERS TAX BREAKS FOR EMPLOYERS & OTHER INCENTIVES

On March 17, the Senate passed H.R. 2847, the Hiring Incentives to Restore Employment (HIRE) Act by a vote of 68 to 29. The House approved the bill on March 4 by a vote of 217 to 201.

The two most important provisions of the HIRE Act are a tax credit provision and a limited "payroll tax holiday" provision, both of which encourage companies to hire unemployed workers in 2010. Other provisions enhance expense treatment for new equipment placed into service in 2010, extend eligibility for tax credit bond issuers, increase funding to highway and transit programs, create new anti-offshore tax abuse measures, and delay the implementation of worldwide allocation of interest.

Credit for Retaining Qualifying New Hires

The HIRE Act provides employers with a tax credit for wages paid to retained workers (for tax years ending after the date of passage) who are qualified individuals that:

1. are employed by the employer on any date during the tax year;

2. continue to be employed by the employer for a period of not less than 52 consecutive weeks; and,

3. receive wages for such employment during the last 26 weeks of the period that are equal to at least 80 percent of the wages received during the first 26 weeks of the period.

Qualified individuals are defined as individuals who:

1. begin work for a qualified employer after Feb. 3, 2010 and before Jan. 1, 2011;

2. certify by signed affidavit (under penalties of perjury) that they were employed for a total of 40 hours or less during the 60-day period ending on the date the employment begins;

3. were not employed to replace another employee of the employer unless that former employee separated from employment voluntarily or for cause; and,

4. are not related to the employer.

A qualified employer is any employer other than a federal, state or local employer (or government instrumentality). Public higher education institutions, however, do qualify as qualified employers.

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The credit for retained workers is included by increasing the amount of the sec. 38(b) business credit. The amount of increase is equal to the lesser of:

1. $1,000; or,

2. 6.2% of the wages paid to the retained worker during the 52 consecutive week period.

The HIRE Act also provides qualified employers with relief from the employer portion of Social Security's Old-Age, Survivors, and Disability Insurance (OASDI) taxes with respect to qualified individuals. The underlying wages must be paid in the last three quarters of 2010. Additionally, these wages must be paid with respect to services performed in a trade or business of a qualified employer or paid in furtherance of the activities constituting the basis of the employer's exemption under section 501. The amount that would have been relieved if the holiday had been in place during the first quarter of 2010 will be treated as an OASDI tax payment made by the employer during the second quarter of 2010. The payroll tax holiday is also available for railroad retirement tax purposes.

Together, these provisions are expected to cost $13 billion over 10 years.

Build America Bonds

The HIRE Act extends the Build America Bond Program to include issuers of:

1. Section 54 Clean Renewable Energy Bonds;

2. Section 54B Qualified Forestry Conservation Bonds;

3. Section 54E Qualified Zone Academy Bonds; and,

4. Section 54F Qualified School Construction Bonds.

Build American Bonds were added to the Code as section 54A by the American Recovery and Reinvestment Tax Act of 2009. In general, section 54A provides a credit to issuers or holders of Build America Bonds equal to 35 percent of the interest payable on the bond in 2010. The credit can be claimed against the alternative minimum tax and unused credits can be carried over. A Build America Bond is any state or local obligation (other than a private activity bond) with interest payments that are otherwise tax-exempt under section 103. These bonds must be issued before 2011 and the issuer must elect to have such bonds treated as Build America Bonds.

This provision is expected to cost $4.6 billion over 10 years.

Other Changes

The HIRE Act also extends the American Reinvestment and Recovery Act of 2009 provision that doubles the amount small businesses can immediately write off on their tax return for capital investments and purchases of new equipment made in 2010 from $125,000 to $250,000 (Section 179 deduction). This provision is expected to cost $35 million over 10 years. Further, the HIRE Act provides the Highway Trust Fund $19.5 billion so it can meet its financial obligations through 2011 while providing that not less than 10% of the expenditures in related highway programs

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be awarded to small business concerns owned or controlled by socially and economically disadvantaged individuals. Finally, the HIRE Act increases the transportation funding baseline from which future legislation is written and shifts estimated tax payments of large corporations (those with at least $1 billion in assets) for July, August, or September of 2015 and 2019 so that a greater amount is due for those payments and a correspondingly lower amount is due for the subsequent payment in order to comply with Congress's "pay as you go" budgetary rules.

The HIRE Act is largely paid for by the inclusion of the Foreign Account Tax Compliance Act of 2009 (FATCA), which is expected to raise $8.7 billion over 10 years by increasing disclosure and withholding requirements for offshore financial institutions. The provisions in the HIRE Act's FATCA subtitle would:

1. impose a 30 percent tax withholding on payments to either: foreign banks and trusts that fail to identify U.S. accounts and their owners and assets to the IRS; or, foreign corporations that do not supply the name, address, and tax identification number of any U.S. individual with at least 10 percent ownership in the firm;

2. extend bearer-bond tax penalties to any such bonds marketed to offshore investors, and prevent the U.S. government from issuing bearer bonds;

3. impose penalties as high as $50,000 on U.S. taxpayers who own at least $50,000 in offshore accounts or assets but fail to report the accounts on their annual income tax return;

4. levy a 40 percent penalty on the amount of any understatement attributed to undisclosed foreign assets;

5. extend to six years the statute of limitations for "substantial" omissions -- exceeding $5,000 and 25 percent of reported income -- derived from offshore assets;

6. require shareholders in passive foreign investment companies to file annual returns;

7. mandate that financial firms file electronic returns with respect to withholding taxes, even if they file fewer than 250 returns annually;

8. codify Treasury regulations that treat foreign trusts as having U.S. beneficiaries if any current, future, or contingent beneficiary as a U.S. person;

9. allow the Treasury Department to presume that a foreign trust has U.S. beneficiaries if a U.S. person directly or indirectly transfers property to the trust;

10. establish a $10,000 minimum failure-to-file penalty for certain foreign-trust related information returns; and,

11. subject dividend equivalent payments included in notional principal contracts and paid to overseas corporations to the same 30 percent withholding tax.

An additional $10 billion would come from a three-year delay, until 2021, of the worldwide interest allocation.

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What Should Businesses Do to Take Advantage of these Changes?

It is important for taxpayers to act quickly in order to receive the benefits offered by this legislation. In order to qualify for the credit, retained workers must begin work before the end of 2010 and remain employed for 52 weeks. Because the credit is only available for workers that were employed for 52 weeks, the increased credit will not be available until the return for the tax year that includes the 52nd is filed. Also, only the OADSI taxes due during 2010 are eligible for relief. Issuers of Build America Bonds must also act quickly because only the interest payable in 2010 is eligible for a credit.

An important aspect of this bill is that retained workers cannot be individuals used to replace other workers, except when the worker leaves voluntarily or is fired for cause, so no benefit is provided by churning. This is a bill aimed at increasing employment and not at reducing employer tax burdens. Together, the HIRE Act's provisions will likely help employers that feel constrained from hiring due to budget constraints but need the help and smaller business that need to make capital and equipment purchases. It will also help to fund infrastructure projects through the expansion of the Build America Bonds program. The HIRE Act, however, is not expected to result in significant increases in employment.

While many desired a larger bill to be passed, the HIRE Act does provide some important benefits that should be considered by employers and bond issuers.

UPDATE:
HAITI (AND CHILE) ASSISTANCE INCOME TAX RELIEF ACT

Thanks to new legislation signed by President Obama, U.S. taxpayers making monetary contributions to the Haiti **as well as Chile** earthquake relief efforts will be able to claim a deduction on their 2009 federal income tax return for these contributions.

The Haiti Assistance Income Tax Relief Act (H.R. 4462) (as updated by H.R. 4783) now allows taxpayers who itemize their deductions to claim a charitable deduction on their 2009 returns for qualified Haiti and Chile disaster relief contributions made after January 11, 2010 and before April 15, 2010. This has been extended from March 1, 2010. The contribution must be monetary to qualify for this special treatment, including donations by check or credit card. Please note that accelerated contributions can only be deducted once, in either 2009 or 2010.

These contributions must be substantiated with a bank record or written communication from a qualified Code Sec. 501(c)(3) charitable organization.

Additionally, individuals who make monetary contributions through their cellular telephones via text message can substantiate their contributions with their telephone bill showing the name of the charitable organization, and the amount and date of the contribution.

If you make any 2010 donations for Haiti or Chile relief and wish to report them as a charitable deduction in 2009, please note this in the data you provide to us to prepare your 2009 tax return. Please contact our office if you have any questions about this legislation or how it may apply to your tax situation.