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CPA

Client Tax Letter

Tax Saving and Planning Strategies *from your* Trusted Business Advisor[sm]

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The Supreme Court's Health Insurance Decision: What It Means to You Now

The Supreme Court has let stand most of the provisions of two federal laws passed in 2010 by holding the requirement that most Americans purchase health insurance constitutional. Those laws, the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act, contain multiple provisions, some of which already have gone into effect. As discussed in the 4th quarter 2012 *CPA Client Tax Letter*, high-income taxpayers will face a 3.8% "Medicare" surtax in 2013. (As a reminder, this tax applies to taxpayers filing joint returns or surviving spouses with modified adjusted gross income (MAGI) over $250,000, married individuals filing separate returns with MAGI over $125,000, and all other individuals with MAGI over $200,000.)

However, the most contentious provision of those laws—the requirement that most Americans purchase health insurance—won't take effect until 2014. That provision is extremely complicated with both penalties for noncompliance and subsidies for people at certain income levels. The IRS has promised more guidance in this area. Expect more information to come in future issues of the *CPA Client Tax Letter* as the time for compliance draws near, and the federal government fills in the details.

That said, some provisions of these major laws go into effect in 2013, as scheduled. If you know about these changes you may be able to make plans accordingly. ■

What's Inside

Trusts and Estates May Owe the Medicare Surtax, Too

The 3.8% Medicare surtax mentioned in the previous article is not limited to individual taxpayers. Trusts and estates also may owe the tax. For trusts and estates, the calculation is slightly different than it is for individuals.

Starting in 2013, trusts and estates will owe the 3.8% surtax on the lesser of (*a*) undistributed net investment income or (*b*) the excess of adjusted gross income (AGI) over the threshold for the highest estate and trust income tax bracket. In 2012, trusts and estates owed the highest tax rate (35%) on taxable income over $11,650. As of this writing, it seems likely that the threshold for the highest estate and trust income tax bracket will be around $12,000 in 2013.

Example: Wendy Miller died a few years ago and left $1 million in trust for her two children. In 2013, the trust earns $60,000 of net investment income, of which $40,000 is distributed to the beneficiaries. Thus, the trust has $20,000 of undistributed net investment income.

If the top trust tax rate applies to taxable income over $12,000 in 2013, and the trust's adjusted gross taxable income is $20,000, it is $8,000 over the threshold. The 3.8% surtax applies to the smaller amount—$8,000 instead of $20,000—in this example.

Executors and trustees may want to reduce investment income in order to reduce exposure to steep income tax rates and the 3.8% surtax. Tax-efficient tactics might include investing in municipal bonds and low-dividend growth stocks, as long as such holdings fit with overall investment plans. ■

Additional Medicare Tax for Certain High-Income Taxpayers

Under current law, all workers pay 1.45% of their wages to the Medicare hospital insurance program. Employers pay a matching 1.45%; self-employed individuals pay both sides, for a total of 2.9%. This tax generally applies to all wages and self-employment income with no cap.

Starting in 2013, some taxpayers will owe an additional 0.9% on wages from employment or self-employment income. The tax applies to taxpayers filing joint returns with combined wages or self-employment income over $250,000 (married taxpayers filing separately with wages or self-employment income over $125,000). For all other taxpayers, the threshold is $200,000. For self-employed taxpayers, the threshold amounts are reduced by the amount of wages taken into account in determining the FICA tax of the taxpayer(s). However, only the excess of the wages or self-employment income that is over the threshold is subject to the additional tax.

Example 1: John Mason, a single taxpayer, works for ABC Corp. with a salary of $220,000 per year. On the first $200,000 of that income, John will pay Medicare tax of 1.45%, and ABC will also pay 1.45% in Medicare tax on John's behalf. On the last $20,000, ABC will continue its 1.45% employer payment, but John's Medicare tax rate increases from 1.45% to 2.35% in 2013. In this example, John pays an extra $180 in tax due to the tax increase: 0.9% of the excess $20,000.

If John is self-employed, the same principle applies. Starting in 2013, assuming that he earned no wages subject to FICA during the year, John has to withhold a total of 2.9% of all earnings up to $200,000 and 3.8% (2.9% plus the additional 0.9%) on all earnings above that. Although self-employed taxpayers are allowed an above-the-line deduction for the employer's share of the Medicare tax, the additional 0.9% Medicare tax is considered the employee's share, so it is not deductible on John's income tax return.

Provisions Aplenty

The Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act together contain over 500 provisions, including more than 40 that add to or amend the Internal Revenue Code.

Note that this 0.9% surtax is on earned income, not on gross income or taxable income.

Spousal situations

As mentioned previously, this tax is applied to the joint wages from employment or self-employment income of married couples filing joint returns over $250,000 per year. However, employers usually have no way of knowing the wages or self-employment income of an employee's spouse, so companies generally will start the extra withholding on an employee's wages over $200,000 per calendar year, which is the threshold for a single taxpayer. Therefore, for a couple where both spouses are employees, withholding typically will be based on each individual spouse's wages. This might lead to improper withholding.

Example 2: Victor Morgan is employed by XYZ Corp. In 2013, Victor's salary is $190,000, so XYZ does not withhold the 0.9% surtax from any of Victor's paychecks. However, Victor's wife, Kim, also has $190,000 of wages in 2013, and her employer also does not withhold the surtax. Thus, the couple's $380,000 of combined wages is over the $250,000 threshold by $130,000. They will owe $1,170: 0.9% of $130,000.

Working couples in such situations may have to make estimated tax payments. Otherwise, they could owe underpayment penalties when they file their tax return for the year at issue due to the withholding shortfall. Other couples will be in the opposite situation, having had more tax withheld than necessary.

Example 3: Gloria Allen earns $240,000 from her job in 2013, so her employer withholds an extra 0.9% on $40,000 of her income. However, Gloria's husband is retired with no earned income, so the couple has a total of $240,000 of combined wages from employment for that year. The Allens do not owe the 0.9% extra Medicare tax, so they will have $360 of surplus withholding (0.9% of $40,000). ■

Higher Hurdles for Medical Deductions and Exemptions

Taxpayers who itemize deductions on Schedule A of Form 1040 can claim excess medical expenses. Under current law, you can deduct unreimbursed expenses for medical care that exceed 7.5% of adjusted gross income (AGI). Starting in 2013, the floor rises to 10% of AGI as a result of health care legislation.

Example 1: Abby Young had $100,000 of AGI in 2012 and $11,000 of deductible unreimbursed medical expenses. Her threshold for deductions was $7,500: 7.5% of $100,000. Thus, Abby can deduct the excess $3,500 ($11,000 minus $7,500) on Schedule A of her 2012 tax return.

Assume that Abby has exactly the same experience in 2013—$100,000 of AGI and $11,000 in deductible unreimbursed medical expenses. This year, her deduction threshold will be $10,000 (10% of $100,000), so her deduction will be reduced to $1,000 in 2013.

Taxpayers 65 and older get a temporary reprieve from this potential tax hike. For them, the 10% threshold won't take effect until 2017. For married couples filing joint returns, this four year tax break is in effect if either spouse is at least 65 years old before the end of the tax year for tax years before 2017.

Affecting early withdrawals

The change in the AGI threshold for medical expense deductions may also affect early withdrawals from IRAs and other retirement plans. Typically, taxpayers owe a 10% penalty on withdrawals before age 59½, in

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Trusted Advice

Capping FSAs

- Flexible spending accounts (FSAs) allow employees to be reimbursed for medical expenses. These accounts usually are funded through voluntary salary reduction agreements.
- No employment or federal income taxes are deducted from FSA contributions, and there are no reporting requirements for FSAs on your income tax return.
- Distributions from a health care FSA can reimburse you for qualified medical expenses. Qualified medical expenses are ones that would be deductible on Schedule A of your tax return.
- Qualified distributions from your FSA are not subject to income tax. Thus, an FSA offers a way to pay for health care with untaxed dollars.
- FSAs are "use-it-or-lose-it" plans, which means that amounts in the account at the end of the plan year cannot be carried over to the next year. However, an employer's FSA plan can provide for a grace period of up to 2½ months after the end of the plan year, during which you can spend FSA money from the previous year.
- Under prior law, there was no limit to the amount you could contribute to a medical FSA. In 2013, contributions to a health care FSA will be limited to $2,500, under the recently upheld legislation. That $2,500 limit will be subject to cost of living adjustments in future years.

addition to regular income tax. The penalty is waived for withdrawals to the extent the withdrawals do not exceed the amount allowable as a deduction for medical care expenses for the tax year.

Example 2: Liz Oldman, age 54, had $100,000 of AGI and $11,000 of deductible unreimbursed medical expenses in 2012. Her 7.5% of AGI threshold was $7,500, and her excess medical bills were $3,500. In this scenario, Liz could have withdraw up to $3,500 from her IRA in 2012; on her 2012 tax return, she'll owe income tax but not the 10% penalty.

Assume that Liz has exactly the same experience in 2013—a $100,000 AGI and $11,000 in unreimbursed medical expenses. This year, her threshold for penalty-free IRA withdrawals will be $10,000, so Liz can withdraw no more than $1,000 from her IRA in 2013 before she owes the 10% penalty. For Liz, these penalty-free distributions ($3,500 in 2012 and $1,000 in 2013) were and still are available, regardless of whether she itemizes deductions on Schedule A of her tax return. ■

Did You Know?

You do not have to withhold income tax on wages paid to household employees unless the employee asks for it, and you agree to it. The employee should complete Form W-4, "Employee's Withholding Allowance Certificate," to help you determine how much income tax to withhold.

Source: Paychex, Inc.

Dealing With Household Employees

Parents of young children often hire helpers, especially if both spouses work. You might need someone to watch the children and do various household chores, including cooking and cleaning.

When your children are old enough to care for themselves and perhaps do some of those tasks, your need for household help may end—but not forever. As you go through life, you might have to hire people to care for an elderly family member or one whose health is failing.

Payments and paperwork

Household workers, of course, must be paid. If those payments reach certain threshold levels, you must file tax forms and comply with applicable tax laws, as described in the following examples. You'll have to obtain an employer identification number and pay employment taxes.

Example 1: Adam and Nicole Benson hire a nanny for their two children. Because they pay her more than the $1,800 threshold in 2013, the Bensons must withhold and pay both Social Security and Medicare tax. Typically, those taxes total 15.3% of a household employee's wages. (A partial Social Security tax reduction has been in effect, but that tax break has not been extended as of this writing.)

Example 2: Jay Martin's wife, Helen, comes home from the hospital after a serious accident. The Martins hire a home aide to help Helen recover. During the first quarter of 2013, because the Martins pay the aide more than the $1,000 threshold in a calendar quarter, they must pay federal unemployment tax: 0.6% of a household employee's wages on wages up to $7,000 per year.

These two examples are not mutually exclusive. If the Bensons pay their nanny over $1,000 in any quarter this year, they also must pay federal unemployment tax. Similarly, if the Martins pay the home aide over $1,800 in 2013, they also must withhold Social Security and Medicare taxes. Moreover, whenever you hire a household employee to work for you on a regular basis, you and the employee must complete the U.S. Citizenship and Immigration Services (USCIS) Form I-9, "Employment Eligibility Verification."

There are some exceptions to these rules. For instance, you won't owe these payroll taxes if you hire your own child and if the child is under age 21. In addition, state taxes also may be a concern.

Over (not under) the table

The official rules, as spelled out in the previous paragraphs, may run into human obstacles. Many household workers prefer to be paid in cash, off the books. They might report little, if any, income and, thus, avoid paying income as well as payroll tax. You, as a household employer, may be tempted to go along, saving the employer's share of payroll tax and cutting down on the paperwork burden.

If you avoid your responsibilities as a household employer, though, you are breaking federal and state laws. What's more, you may be leaving yourself open to severe financial consequences.

Example 3: Mary Edwards hired a nurse to care for her ailing husband. The nurse worked for Mary for many years under the radar. Mary never complied with any of the requirements described in this article. Years later, the nurse applied for Social Security and Medicare benefits, listing her years in the Edwards household as part of her work record. Mary eventually had to pay huge amounts of back payroll tax plus interest and penalties. There is no time limit on the ability of the IRS to demand unpaid payroll tax if the employer does not file an employment tax return.

Additionally, the money you spend on household employees may qualify for tax benefits, such as medical deductions and the child and dependent care credit. However, if you claim such deductions and credits, a subsequent audit of your income tax return might reveal a failure to file required returns and pay the tax relating to hiring household employees. Again, the total amount you could owe, counting interest and penalties, could be enormous.

Savvy solutions

If you hire household employees, you're required to comply with all the rules and pay the appropriate taxes. Instead of coping with all the forms yourself, you can seek expert assistance.

One approach is to deal with an agency when you need a housekeeper, home aide, etc. The people who will come to your home will be employees of the agency; the agency will bear all of the employer responsibilities, so you won't have to do so. You will have to pay the agency fees, though, and that can be expensive.

Another tactic is to call in a company that specializes in payroll reporting and recordkeeping. A payroll service company can help you deal with all the paperwork in order to help ensure that you comply with IRS regulations and pay your household employees' appropriate federal and state tax requirements. Moreover, our office can help you deal with the tax filing requirements. ■

Trusted Advice

Employment Eligibility

- No later than the first day of work, household employees must complete the employee section of the U.S. Citizenship and Immigration Services "Employment Eligibility Verification," Form I-9.
- Employers must complete the employer section of Form I-9 by examining documents presented by the employee as evidence of his or her identity and employment authorization.
- Acceptable documents to establish identity and employment authorization appear on the last page of Form I-9.
- Employers must retain the completed Form I-9 for either three years after the date of hire or one year after the date employment is terminated, whichever is later.

Taxes on Gambling Winnings

For gamblers, the tax code offers unfavorable odds. Win, and you owe tax at your ordinary income rate, now as high as 35%. Lose....and you lose. There is no tax benefit.

However, savvy gamblers can offset taxable winnings with their losses if they can document those losses. The better your recordkeeping, the less tax you'll ultimately owe if you should happen to get lucky.

House rules

Casual gamblers (that is, persons not in the trade or business of gambling) should report any gambling winnings on line 21 of Form 1040 under "other income." Those winnings include money won at a casino or race track. Lotteries, bingo, raffles, etc., are all considered gambling, so you must report any success in those areas.

Example 1: Paul Sawyer wins $1 million in the lottery, payable over 20 years. In 2013, Paul sells the rights to his future payments for $400,000. On his 2013 tax return, Paul reports $400,000 of gambling winnings. (If Paul had chosen to receive $50,000 per year, he would report $50,000 on his 2013 tax return.) According to cases such as *U.S. v. Maginnis*, decided by the Court of Appeals for the Ninth Circuit in 2004, money received from such a sale is taxed as ordinary income, so sellers won't get the favorable tax rate on long-term capital gains.

You'll also owe tax if you win a prize instead of cash. Typically, the entity awarding the prize will put a fair market value on the car, trip, or other item and report that to the IRS on Form 1099. You'll owe tax on the reported amount. If you think the value is overstated, you can report a lower amount, but you should be ready to support your claim to the IRS, if challenged. For example, make sure you can prove you sold the "$2,000 flat screen TV" you won to an unrelated third party for $1,200 immediately after you received it.

Reporting and withholding

Tax payers are supposed to report gambling winnings, like all forms of income, in full. To help enforce compliance, the gaming establishment must report certain winnings to the IRS on Form W-2G. For example, winnings (not reduced by the wager) of $1,200 or more from a slot machine must be reported; the same is true for winnings (reduced by the wager or buy-in) of more than $5,000 from a poker tournament. In many cases, 25% will be withheld and sent to the IRS on winnings over $5,000.

Taxpayers who do not provide a Social Security number when requested may be subject to 28% backup withholding.

Regardless of whether anything was withheld, you must report all of your gross gambling winnings on line 21 of Form 1040. This is not where you net your gambling winnings and losses.

Listing your losses

In order to get any tax benefit from gambling losses, you must itemize deductions on Schedule A of Form 1040. If you take the standard deduction instead, you'll owe tax on the full amount of your gambling winnings.

On Schedule A, you can list all your gambling losses. In effect, this will trim the tax on your gambling winnings.

You can claim losses up to the amount of gambling winnings you report. Keep in mind, though, the trade-off is not perfect because gambling winnings increase your adjusted gross income (AGI), and a higher AGI may reduce your ability to claim various tax deductions and credits.

Example 2: Joan Miller reports $10,000 of poker winnings on line 21 of her 1040. On Schedule A, Joan claims $6,000 of losses from poker, other table games, and horse racing bets. In effect, Joan winds up paying tax on $4,000 of gambling winnings. ■

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