SELF-STUDY CONTINUING PROFESSIONAL EDUCATION

# 2009 and Spring 2010 Tax Acts

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# 2009 and Spring 2010 Tax Acts (D10TG10)

## OVERVIEW

| | |
|---|---|
| **COURSE DESCRIPTION:** | This interactive self-study course covers significant provisions of the 2009 and spring 2010 tax acts, including the American Recovery and Reinvestment Act of 2009, the HIRE Act, and 2010 health care legislation. |
| **PUBLICATION/REVISION DATE:** | September 2010 |
| **PREREQUISITE/ADVANCE PREPARATION:** | Basic knowledge of taxation |
| **CPE CREDIT:** | 4 QAS Hours, 4 Registry Hours |
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| **CFP® CREDIT:** | 2 CE Hours – CFP® credit hours are one half the number of CPE credit hours. |
| **FIELD OF STUDY:** | Taxes |
| **EXPIRATION DATE:** | **September 30, 2011** |
| **KNOWLEDGE LEVEL:** | Basic |

## LEARNING OBJECTIVES

### Lesson 1: American Recovery and Reinvestment Act of 2009

Completion of this lesson will enable you to:

- Identify the changes to various credits affecting individuals, and summarize the requirements of new credits such as the Making Work Pay Credit, and the First-time Homebuyer Credit.
- Summarize the modifications made to COBRA coverage of unemployed workers.

### Lesson 2: Hiring Incentives to Restore Employment (HIRE) Act

Completion of this lesson will enable you to:

- Determine the effects of the HIRE Act on payroll taxes, unemployed workers, retained workers, and Section 179 expensing limits.

### Lesson 3: Health Care Legislation

Completion of this lesson will enable you to:

- Define those subject to the penalty for no health insurance, those eligible for a tax credit and those subject to qualified health plans as these terms apply to the Health Care Act.
- Recognize the changes to health care legislation due to the Health Care Act, including the health coverage excise tax, “free choice” vouchers, the health insurance credit for small employers and extension of health benefits for adult children.

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# Lesson 1: American Recovery and Reinvestment Act of 2009

### Learning Objectives

Completion of this lesson will enable you to:

- Identify the changes to various credits affecting individuals, and summarize the requirements of new credits such as the Making Work Pay Credit, and the First-time Homebuyer Credit.
- Summarize the modifications made to COBRA coverage of unemployed workers.

## Making Work Pay Credit

**New Law.** The Recovery Act provides eligible individuals with a refundable income tax credit for tax years beginning in 2009 and 2010. (IRC Sec. 36A, as added by Act Sec. 1001(a)) The credit is the lesser of (1) 6.2% of an individual's earned income or (2) $400 ($800 for a joint return). (IRC Sec. 36A(a))

> **Observation:** Thus, a taxpayer with $6,451.61 of earned income ($12,903.22 on a joint return) would get the maximum credit. Because the credit rate (6.2%) is the same as the social security tax rate, the credit can be thought of as offsetting social security tax on those amounts of earned income.
>
> **Illustration 1:** Taxpayer A, a single individual, had $5,400 of earned income in 2009. A's credit is $334.80 ($5,400 × 6.2%).
>
> **Illustration 2:** Taxpayers B and C, joint filers, had $10,800 of earned income in 2009. Their credit is $669.60 ($10,800 × 6.2%).
>
> **Illustration 3:** Taxpayer D, a single individual, had $12,000 of earned income in 2009. D gets the maximum $400 credit, which is less than $744 ($12,000 × 6.2%).
>
> **Illustration 4:** Taxpayers E and F, joint filers, had $24,000 of earned income in 2009. They get the maximum $800 credit, which is less than $1,488 ($24,000 × 6.2%).

For these purposes, the earned income definition is the same as for the earned income tax credit with two modifications: (a) it does not include net earnings from self-employment which are not taken into account in computing taxable income; and (b) it includes combat pay excluded from gross income under IRC Sec. 112. (IRC Sec. 36A(d)(2))

The credit is phased out at a rate of 2% of the eligible individual's modified AGI above $75,000 ($150,000 for a joint return). (IRC Sec. 36A(b))

> **Observation:** The maximum credit of $400 is completely phased out at modified AGI of $95,000. For joint filers, the maximum credit of $800 is completely phased out at modified AGI of $190,000.
>
> **Illustration 5:** Taxpayer G, a single individual, was eligible for the maximum credit of $400 but had modified AGI of $90,000. G's credit is $100: $400 − [2% × ($90,000 − $75,000)].

**Illustration 6:** Taxpayers H and I, joint filers, were eligible for the maximum credit of $800 but had modified AGI of $180,000. Their credit is $200: $800 − [2% × ($180,000 − $150,000)].

**Illustration 7:** Taxpayer J, a single individual, was eligible for the maximum credit of $400 but had modified AGI of $100,000. J gets no credit, because 2% of $25,000 ($100,000 − $75,000) equals $500, which wipes out the $400 credit.

**Illustration 8:** Taxpayers K and L, joint filers, were eligible for the maximum credit of $800 but had modified AGI of $200,000. They get no credit, because 2% of $50,000 ($200,000 − $150,000) equals $1,000, which wipes out the $800 credit.

For 2009, the credit was reduced by the recovery payments under the Veterans Administration, Railroad Retirement Board, and the Social Security Administration as well as the credit for certain government workers, as discussed on page 1-19. (IRC Sec. 36A(c))

An eligible individual is any individual other than: (1) a nonresident alien; (2) an individual with respect to whom another may claim a dependency deduction for a tax year beginning in a calendar year in which the eligible individual's tax year begins; and (3) an estate or trust. (IRC Sec. 36A (d)(1)(A)) An individual is not eligible if he does not include his social security number on the return. For joint filers, this requirement is met if the social security number of one of the spouses is included on the return. (IRC Sec. 36A(d)(1)(B))

Any credit or refund allowed or made to an individual under this provision is not taken into account as income and is not taken into account as resources for the month of receipt and the following two months for purposes of determining eligibility of the individual or any other individual for benefits or assistance, or the amount or extent of benefits or assistance, under any Federal program or under any State or local program financed in whole or in part with Federal funds.

Taxpayers' reduced tax liability under the provision has been expeditiously implemented through revised income tax withholding schedules produced by the IRS.

## Earned Income Tax Credit Increased

Low-income and moderate-income workers may be eligible for the refundable earned income tax credit ("EITC"). Eligibility for the EITC is based on earned income, adjusted gross income, investment income, filing status, and immigration and work status in the U.S. The amount of the EITC is based on the presence and number of qualifying children in the worker's family, as well as on adjusted gross income and earned income.

The EITC generally equals a specified percentage of earned income up to a maximum dollar amount. The maximum amount applies over a certain income range and then diminishes to zero over a specified phase-out range. For taxpayers with earned income (or adjusted gross income (AGI), if greater) in excess of the beginning of the phase-out range, the maximum EITC amount is reduced by the phase-out rate multiplied by the amount of earned income (or AGI, if greater) in excess of the beginning of the phase-out range. For taxpayers with earned income (or AGI, if greater) in excess of the end of the phase-out range, no credit is allowed.

An individual is not eligible for the EITC if the aggregate amount of disqualified income of the taxpayer for the tax year exceeds $3,100 (for 2010). This threshold is indexed for inflation. Disqualified income is the sum of: (1) interest (taxable and tax exempt); (2) dividends; (3) net rent and royalty income (if greater than zero); (4) capital gains net income; and (5) net passive income (if greater than zero) that is not self-employment income.

Under an advance payment system, eligible taxpayers may elect to receive the credit in their paychecks, rather than waiting to claim a refund on their tax returns filed by April 15 of the following year.

An unmarried individual may claim the EITC if he or she files as a single filer or as a head of household. Married individuals generally may not claim the EITC unless they file jointly.

Three separate credit schedules apply: one for taxpayers with no qualifying children, one for taxpayers with one qualifying child, and one for taxpayers with more than one qualifying child.

**New Law.** The Recovery Act increases the EITC credit percentage for families with three or more qualifying children to 45% for 2009 and 2010. (IRC Sec. 32(b)(3), as amended by Act Sec. 1002 (a)) For example, in 2010, taxpayers with three or more qualifying children may claim a credit of 45% of earnings up to $12,590, resulting in a maximum credit of $5,666.

The Recovery Act also increases the threshold phase-out amounts for married couples filing joint returns to $5,000 above the threshold phase-out amounts for singles, surviving spouses, and heads of households) for 2009 and 2010 (subject to a further increase in 2010 for inflation; 2010 amount is $5,010). (IRC Sec. 32(b)(3)) For example, in 2010, the maximum credit of $3,050 for one qualifying child is available for those with earnings between $8,970 and $16,450 ($21,460 if married filing jointly. The credit begins to phase down at a rate of 15.98% of earnings above $16,450 ($21,460 if married filing jointly). The credit is phased down to $0 at $35,535 of earnings ($40,545 if married filing jointly).

## Refundable Child Credit Threshold Lowered

Currently, a taxpayer receives a $1,000 tax credit for each qualifying child under the age of 17. To the extent the child credit exceeds the taxpayer's tax liability the taxpayer is eligible for a refundable credit (the additional child tax credit) equal to 15% of earned income in excess of a threshold dollar amount (the earned income formula).

For 2009, under pre- Act law, the earned income formula for the determination of the refundable child credit was 15% of earned income in excess of $12,550 (as indexed for inflation).

Families with three or more children may determine the additional child tax credit using the "alternative formula," if this results in a larger credit than determined under the earned income formula. Under the alternative formula, the additional child tax credit equals the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income credit.

**New Law.** The Recovery Act modifies the earned income formula for the determination of the refundable child credit to apply to 15% of earned income in excess of $3,000 for tax years beginning in 2009 and 2010. (IRC Sec. 24(d)(4), as amended by Act Sec. 1003(a))

**Observation:** The change to $3,000 for 2009 and 2010 is pro-taxpayer in that it can result in a larger refundable credit than would have been the case under prior law.

**Illustration:** In 2010, H and W, joint filers, have earned income of $15,500 and one qualifying child. H and W's $1,000 child tax credit is fully refundable, because 15% of the excess of their earned income ($15,500) over $3,000 is $1,875 [($15,500 − $3,000) × 15% = $1,875], which is greater than the $1,000 child tax credit to which they are entitled.

## American Opportunity Tax Credit

Under pre-Act law, individual taxpayers may claim a nonrefundable education credit, the Hope credit, against Federal income taxes of up to $1,800 (for 2009) per eligible student per year for qualified tuition and related expenses paid for the first two years of the student's post-secondary education in a degree or certificate program. The Hope credit rate is 100% of the first $1,200 of qualified tuition and related expenses, and 50% of the next $1,200 of qualified tuition and related expenses.

The Hope credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between $50,000 and $60,000 ($100,000 and $120,000 for joint filers) for 2009.

The qualified tuition and related expenses must be incurred on behalf of the taxpayer, his spouse, or dependent. The Hope credit is available with respect to an individual student for two tax years, provided that the student has not completed the first two years of post-secondary education before the beginning of the second tax year. It is available in the tax year the expenses are paid, provided the education is furnished to the student during that year or an academic period beginning during the first three months of the next tax year.

Qualified tuition and related expenses include tuition and fees (excluding nonacademic fees) required to be paid to an eligible educational institution as a condition of enrollment or attendance of an eligible student at the institution. Charges and fees associated with meals, lodging, insurance, transportation, and similar personal, living, or family expenses aren't eligible for the credit. The expenses of education involving sports, games, or hobbies are not qualified tuition and related expenses unless this education is part of the student's degree program.

**New Law.** The Recovery Act modifies the Hope credit for tax years beginning in 2009 or 2010. (IRC Sec. 25A(i)) The modified credit is referred to as the American opportunity tax credit. The credit is up to $2,500 per eligible student per year for qualified tuition and related expenses paid for each of the first four years of the student's post-secondary education in a degree or certificate program. The modified credit rate is 100% of the first $2,000 of qualified tuition and related expenses, and 25% of the next $2,000 of qualified tuition and related expenses. (IRC Sec. 25A(i)(1))

The definition of qualified tuition and related expenses is expanded to include course materials. (IRC Sec. 25A(i)(3))

The credit is available with respect to an individual student for four years, provided he has not completed the first four years of post-secondary education before the beginning of the fourth tax year. (IRC Sec. 25A(i)(2))

The credit is phased out ratably for taxpayers with modified AGI between $80,000 and $90,000 ($160,000 and $180,000 for joint filers). (IRC Sec. 25A(i)(4)) The credit may be claimed against AMT. (IRC Sec. 25A(i)(5))

Subject to an exception, 40% of a taxpayer's otherwise allowable credit is refundable. No portion of the credit is refundable if the taxpayer claiming the credit is a child subject to the "kiddie tax" under IRC Sec. 1(g). (IRC Sec. 25A (i)(6))

## Computers as Education Expenses under 529 Plans

A person can make nondeductible cash contributions to a qualified tuition program (QTP, or 529 plan) on behalf of a designated beneficiary. The earnings on the contributions build up tax-free and distributions from a QTP are excludable to the extent used to pay for qualified higher education expenses. A QTP is a tax-exempt program established and maintained by a state (including a state agency or instrumentality), or one or more eligible educational institutions (including private ones) under which a taxpayer may: (1) buy tuition credits or certificates on behalf of a designated beneficiary which entitle the beneficiary to a waiver or payment of qualified higher education expenses—i.e., a prepaid educational services account, or (2) make contributions to an account set up to meet the designated beneficiary's qualified higher education expenses—i.e., an educational savings account.

Under pre-Act law, qualified higher education expenses for QTP purposes are: (a) tuition, fees, books, supplies, equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution, and expenses for special needs services; and (b) room and board costs (subject to a limit) for students who are at least half-time.

**New Law.** Under the Recovery Act, expenses paid or incurred in 2009 or 2010 for the purchase of any computer technology or equipment or Internet access or related services qualify as qualified higher education expenses under QTPs if such technology, equipment, or services are to be used by the QTP beneficiary or his family during any of the years the beneficiary is enrolled at an eligible educational institution. (IRC Sec. 529(e)(3)(A) (iii)) Expenses for computer software designed for sports, games or hobbies do not qualify unless the software is predominantly educational in nature. (IRC Sec. 529(e)(3)(A)(iii))

**Note:** This temporary change to the definition of higher education expenses also applies to education savings accounts (ESAs).

## First-time Homebuyer Credit Expanded

**Note:** The first-time homebuyer credit as discussed in this section was subsequently extended and expanded by the Worker, Homeownership and Business Assistance Act of 2009.

Under pre-Act law, for qualifying purchases of principal residences in the U.S. after April 8, 2008, and before July 1, 2009, eligible first-time homebuyers may claim a refundable tax credit equal to the lesser of 10% of the purchase price of a principal residence or $7,500 ($3,750 for married individuals filing separately).

A taxpayer is considered a first-time homebuyer if he (and spouse, if married) had no present ownership interest in a principal residence in the U.S. during the 3-year period before the purchase of the home to which the credit applies.

**Observation:** Because only prior ownership in a principal residence is considered, it's possible for a taxpayer who already owns a vacation home to claim the new credit, if he otherwise qualifies. For example, a taxpayer whose principal residence for at least three years has been a rental apartment in the city, and who owns a seaside home, could claim the credit for the purchase of a new principal residence if his modified AGI doesn't exceed the phase-out levels discussed below.

Eligible first-time homebuyers who purchase a principal residence after December 31, 2008, and before July 1, 2009, may elect to treat the purchase as made on December 31, 2008.

The first-time homebuyer credit phases out for individual taxpayers with modified AGI between $75,000 and $95,000 ($150,000–$170,000 for joint filers) for the year of purchase.

The credit for new homebuyers is recaptured ratably over fifteen years, with no interest charge, beginning with the second tax year after the tax year in which the home is purchased. For each tax year of the 15-year recapture period, the credit is recaptured as an additional income tax amount equal to 6⅔ % of the amount of the credit. This repayment obligation may be accelerated or forgiven under certain exceptions.

**Observation:** In other words, the credit for new homebuyers is the equivalent of a long-term interest-free loan from the government.

**New Law.** The Recovery Act increases the maximum homebuyer credit to $8,000. (IRC Sec. 36(b)) The Recovery Act also extends the credit so that it applies to purchases before December 1, 2009 (IRC Sec. 36(h)). A 2009 purchase can be treated as made on December 31, 2008 (IRC Sec. 36(g)).

In addition, it waives the recapture of the credit for qualifying home purchases after December 31, 2008. This waiver of recapture applies without regard to whether the taxpayer elects to treat the purchase in 2009 as occurring on December 31, 2008. If the taxpayer disposes of the home or the home otherwise ceases to be the principal residence of the taxpayer within 36 months from the date of purchase, the pre-Recovery Act rules for recapture of the credit apply. (IRC Sec. 36(f)(4)(D))

The Recovery Act also provides that no D.C. homebuyer credit is allowed to any taxpayer with respect to a 2009 residence purchase if a credit is first-time homebuyer credit is allowable to the taxpayer under IRC Sec. 36. (IRC Sec. 1400C(e)(4))

## Subsidy for COBRA Coverage of Unemployed Workers

The Recovery Act provides a 65% subsidy for COBRA continuation premiums for up to nine months for workers who have been involuntarily terminated, and for their families. This subsidy also applies to health care continuation coverage if required by states for small employers.

To qualify for premium assistance, a worker must be involuntarily terminated between September 1, 2008, and December 31, 2009. The subsidy terminates upon offer of any new employer-sponsored health care coverage or Medicare eligibility. Workers who were involuntarily terminated between September 1, 2008, and February 17, 2009, but failed to initially elect COBRA because it was unaffordable, must be given an additional 60 days to elect COBRA and receive the subsidy.

**Note:** The cutoff date for the COBRA subsidy was extended from the December 31, 2009 date discussed in this section to May 31, 2010, through a series of Acts (see the Department of Defense Appropriations Act of 2010, the Temporary Extension Act of 2010, and the Continuing Extension Act of 2010).

Any COBRA qualified beneficiary associated with the related covered employee, such as a dependent child of an employee, who is covered immediately before the qualifying event—i.e., the involuntary termination of the covered employee's employment that occurs during the period between September 1, 2008, and the period ending December 31, 2009—can be an individual eligible for the COBRA subsidy. A covered employee must involuntarily lose his job, he can't have left voluntarily. The individual must also be eligible for COBRA coverage, or similar state coverage, during this period.

If the worker pays 35% of the premium, the group health plan must treat that individual as having paid the full premium required for COBRA continuation coverage.

**Observation:** The IRS (IR-2009-15) explains that these provisions became effective on February 17, 2009, but that under a transition rule the regular premium amount may continue to be paid for up to two months after February 17, 2009 (e.g., for March and April), and that the subsidy can be provided retroactively.

The Recovery Act also provides a mechanism for reimbursing the person (the employer) to which premiums are payable for the difference between the full premium and the amount paid by the worker. The employer may be reimbursed for the difference between the full premium and the amount paid by the worker (up to 65%).

Employers who are entitled to the reimbursement are allowed to take a refundable credit on Form 941 to reduce their quarterly employment tax liability. Alternatively, they can apply to the IRS to receive the money back.

The following lines have been added to Form 941 to reflect the Recovery Act's changes in COBRA coverage:

- Line 12a—COBRA premium assistance payments. The form instructions note that employers should only report the COBRA premium assistance payments that they made on behalf of workers. This amount should be 65% of eligible workers' total COBRA premium payments. Employers should not include on this line any amounts that they received from the workers.

- Line 12b—Number of individuals provided assistance. This line reports the number of individuals provided COBRA premium assistance reported on line 12a. The balance due (or overpayment) on the return is now determined by subtracting: (1) the sum of the total tax deposits and the amount reported on line 12a, from (2) the total tax liability.

Schedule B of Form 941, Report of Tax Liability for Semiweekly Schedule Depositors, has also been revised. There are no changes to the way that semiweekly depositors record their tax liabilities on Schedule B. Tax liabilities on Schedule B should still equal line 10 of Form 941. Line 10 is an employer's tax liability for the quarter before consideration of the refundable COBRA credit.

No additional information relating to the COBRA subsidy beyond that requested on Lines 12a and 12b is to be submitted with Form 941 (either electronically or in paper form). But, those claiming the credit must maintain supporting documentation, including, but not limited to:

- Information on the receipt, including dates and amounts, of the assistance eligible individuals' 35% share of the premium;
- For an insured plan, copy of invoice or other supporting statement from the insurance carrier and proof of timely payment of the full premium to the insurance carrier required under COBRA;
- For a self-insured plan, proof of the premium amount and proof of the coverage provided to the assistance eligible individuals;
- Attestation of involuntary termination, including the date (which must be during the period from September 1, 2008, to December 31, 2009), for each covered employee whose involuntary termination is the basis for eligibility for the subsidy;
- Proof of each assistance eligible individual's eligibility for COBRA coverage at any time during the period from September 1, 2008, to December 31, 2009, and election of COBRA coverage;
- A record of the social security numbers (SSNs) of all covered employees, the amount of the subsidy reimbursed for each covered employee, and whether the subsidy was for one, two, or more individuals; and
- Other documents necessary to verify the correct amount of reimbursement.

**Observation:** On its website (**www.irs.gov**), in a Question & Answer format, the IRS has explained how employers are to administer the COBRA continuation premium subsidy provided to former employees and others covered by COBRA. In particular, the information helps employers claim the COBRA continuation coverage credit on payroll tax forms to obtain speedy reimbursement for their subsidy to employees who involuntarily lose their jobs. The IRS has also issued Notice 2009-27 to provide additional guidance on the new COBRA premium subsidy. A primary topic of interest tackled in the notice is the IRS' liberal interpretation of what constitutes "involuntary termination," a key condition for the premium reduction credit. Lastly, the Department of Labor has provided FAQ's and a fact sheet entitled COBRA Premium Reduction, both available on their website (**www.dol.gov**).

The subsidy isn't included in an individual's income when paid (IRC Sec. 139C). However, under phase-out provisions, individuals whose modified adjusted gross income (MAGI) exceeds $125,000 ($250,000 for joint return filers) will have to increase their tax liability on their return for the year of the subsidy to repay part or all of the subsidy. The full amount of the subsidy must be repaid as an additional tax if a taxpayer's MAGI exceeds $145,000 ($290,000 for joint return filers).

**Illustration:** Fred, a bond trader who files as a single taxpayer, is laid off from work on August 31, 2009, and begins receiving COBRA continuation coverage effective September 1, 2009. Despite his high income ($1.2 million MAGI), Fred is eligible for COBRA premium assistance for the period September 1, 2009 through June 30, 2010. However, all of the COBRA premium assistance Fred receives in 2009 will be recaptured. Note, however, that under IRC Sec. 139C(b)(3), high income taxpayers who are otherwise assistance eligible individuals may elect not be treated as such. In effect they can elect to waive assistance and thereby avoid recapture when they file their returns. In 2010, Fred's MAGI falls to below $125,000. The COBRA premium assistance Fred receives in 2010 will not be subject to recapture.

## SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Ruby, an unmarried taxpayer, has $12,500 of earned income in 2010. Calculate the amount of Ruby's refundable income tax credit under the 2009 Recovery Act.

   a. $400.

   b. $775.

   c. $800.

2. How do the earned income credit (EIC) percentage changes affect families?

   a. Allows the EIC for taxpayers who have disqualified income that exceeds $3,100 for 2009.

   b. Increased the maximum earned income dollar amount for families with three or more children.

   c. Changed the applicable EIC credit percentages for 2009 and 2010 for families with one or two qualifying children.

   d. Increased the beginning point of EIC phase-out range for joint filers.

3. How does the 2009 Recovery Act affect the child tax credit?

   a. Increases the child tax credit to $1,500.

   b. Changes the earned income formula for determining the refundable tax credit.

   c. Any taxpayer earning less than $10,000 can only claim half of the refundable child tax credit.

4. How does the 2009 Recovery Act modify the pre-2009 Recovery Act Hope credit?

   a. Increases the maximum credit amount for qualified tuition and related (QT&R) expenses from $1,800 to $3,000.

   b. Allows the Hope credit for the first four years of the student's post-secondary education in a certificate program.

   c. Disallows the credit to be claimed against alternative minimum tax (AMT) liability.

   d. Expands the definition of QT&R (excluding course materials).

5. Which of the following examples is considered a qualifying higher education expense under the 529 plans for 2009 and 2010?

   a. Internet access used to research family genealogy.

   b. Laptop used by the beneficiary's sister while the beneficiary is enrolled in college.

   c. Gaming software.

6. Which of the following statements best describes how the 2009 Recovery Act recapture rules affect first-time homebuyers?

   a. All first-time homebuyers who purchase a home after December 31, 2008 and before December 1, 2009, for which the homebuyer credit is allowed, are subject to the regular recapture rule.

   b. The accelerated recapture rule will apply in certain circumstances to any principal residence purchased after December 31, 2008 and before December 1, 2009.

7. David is laid off from his job and is eligible to elect COBRA continuation health coverage. His former employer pays $300 per month for his coverage. Under the 2009 Recovery Act, what amount will David have to pay per month for COBRA continuation coverage?

   a. $90.

   b. $105.

   c. $195.

   d. $300.

## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Ruby, an unmarried taxpayer, has $12,500 of earned income in 2010. Calculate the amount of Ruby's refundable income tax credit under the 2009 Recovery Act. **(Page 1)**

   **a. $400. [This answer is correct. Ruby's earned income exceeds the $400 maximum refundable income tax credit amount. Under the 2009 Recovery Act, the amount of credit Ruby can receive is the lesser of 6.2% of her earned income or $400 if filing single.]**

   b. $775. [This answer is incorrect. This is the amount Ruby would receive if her earned income, multiplied by 6.2%, is less than the maximum credit amount a single individual can receive.]

   c. $800. [This answer is incorrect. This is the amount Ruby would receive if she is filing jointly and her total combined earned income multiplied by 6.2% exceeds $800.]

2. How do the earned income credit (EIC) percentage changes affect families? **(Page 3)**

   a. Allows the EIC for taxpayers who have disqualified income that exceeds $3,100 for 2009. [This answer is incorrect. No EIC is allowed if the taxpayer's disqualified income exceeds a specified inflation-adjusted dollar amount for the year.]

   b. Increased the maximum earned income dollar amount for families with three or more children. [This answer is incorrect. The 2009 Recovery Act does not increase the maximum earned income dollar amount for families with three or more children for tax years 2009 and 2010. However, to provide larger families with additional tax relief, the 2009 Recovery Act increases the EIC credit percentage for families with three or more qualifying children.]

   c. Changed the applicable EIC credit percentages for 2009 and 2010 for families with one or two qualifying children. [This answer is incorrect. The 2009 Recovery Act does not change the applicable EIC credit percentages in effect for 2009 and 2010 for families with one or two qualifying children. However, it increased the credit percentage for workers with three or more qualifying children.]

   **d. Increased the beginning point of EIC phase-out range for joint filers. [This answer is correct. To provide additional marriage penalty relief, the 2009 Recovery Act provides higher threshold phase-out amounts for married couples filing joint returns.]**

3. How does the 2009 Recovery Act affect the child tax credit? **(Page 3)**

   a. Increases the child tax credit to $1,500. [This answer is incorrect. The refundable portion of the child tax credit remains at $1,000 per qualifying dependent child under age 17 through 2010.]

   **b. Changes the earned income formula for determining the refundable tax credit. [This answer is correct. The 2009 Recovery Act modifies the previous formula for determining the refundable child tax credit to apply to 15% of earned income in excess of $3,000 for tax years 2009 and 2010.]**

c. Any taxpayer earning less than $10,000 can only claim half of the refundable child tax credit. [This answer is incorrect. Under the 2009 Recovery Act, a taxpayer with one qualifying child, who earns as little as $9,667 but has no income tax liability, may claim the full refundable child tax credit.]

4. How does the 2009 Recovery Act modify the pre-2009 Recovery Act Hope credit? **(Page 4)**

a. Increases the maximum credit amount for qualified tuition and related (QT&R) expenses from $1,800 to $3,000. [This answer is incorrect. The Recovery Act modifies the Hope credit by increasing the maximum credit amount from $1,800 to $2,500 per eligible student per year for qualified QT&R expenses.]

**b. Allows the Hope credit for the first four years of the student's post-secondary education in a certificate program. [This answer is correct. To claim the Hope credit, the student could not have completed the first two years of the post-secondary education before the beginning of the tax year for which the credit is claimed. The Recovery Act allows the credit for the first four years of the student's post-secondary education in a degree or certificate program.]**

c. Disallows the credit to be claimed against alternative minimum tax (AMT) liability. [This answer is incorrect. Under the pre-2009 Recovery Act law, for tax years beginning after December 31, 2008, the Hope credit could not be claimed against a taxpayer's AMT liability. The Recovery Act now permits the credit to be claimed against AMT liability.]

d. Expands the definition of QT&R (excluding course materials). [This answer is incorrect. Generally, under pre-2009 Recovery Act law, QT&R expenses for the Hope credit included, with specific exceptions, tuition and fees (excluding nonacademic fees) required for the enrollment or attendance of the taxpayer, his or her spouse, or tax dependent, at a post-secondary educational institution eligible to participate in the federal student loan program. However, the new Recovery Act has expanded the definition of QT&R expenses to include tuition, fees, and course materials.]

5. Which of the following examples is considered a qualifying higher education expense under the 529 plans for 2009 and 2010? **(Page 5)**

a. Internet access used to research family genealogy. [This answer is incorrect. Unless the genealogy research is predominately educational in nature, this does not qualify as a higher education expense.]

**b. Laptop used by the beneficiary's sister while the beneficiary is enrolled in college. [This answer is correct. According to the 2009 Recovery Act, computer equipment used by the beneficiary's family during any year that the beneficiary is enrolled at an eligible educational institution qualifies under the higher education expense category under the 529 Plan.]**

c. Gaming software. [This answer is incorrect. Gaming software generally is not considered predominately educational.]

6. Which of the following statements best describes how the 2009 Recovery Act recapture rules affect first-time homebuyers? **(Page 6)**

   a. All first-time homebuyers who purchase a home after December 31, 2008, and before December 1, 2009, for which the homebuyer credit is allowed, are subject to the regular recapture rule. [This answer is incorrect. Under the 2009 Recovery Act, the regular recapture rule does not apply to a principal residence purchased after December 31, 2008, and before December 1, 2009 for which a first-time homebuyer credit is allowed.]

   **b. The accelerated recapture rule will apply in certain circumstances to any principal residence purchased after December 31, 2008, and before December 1, 2009. [This answer is correct. For a principal residence purchased after December 31, 2008, and before December 1, 2009, for which a first-time homebuyer credit is allowed; the accelerated recapture rule will apply only if the taxpayer disposes of the residence, or the residence ceases to be the principal residence of the taxpayer or the taxpayer's spouse, during the 36-month period beginning on the date of purchase of that residence by the taxpayer.]**

7. David is laid off from his job and is eligible to elect COBRA continuation health coverage. His former employer pays $300 per month for his coverage. Under the 2009 Recovery Act, what amount will David have to pay per month for COBRA continuation coverage? **(Page 6)**

   a. $90. [This answer is incorrect. $90.00 is the amount David would have to pay for COBRA continuation coverage if his portion of the $300 cost to his employer under the 2009 Recovery Act was 30%.]

   **b. $105. [This answer is correct. Under the 2009 Recovery Act, David has to pay only 35% of his employer's premium. Therefore, David will have to pay $105, which is 35% of $300 for COBRA continuation coverage.]**

   c. $195. [This answer is incorrect. $195.00 is the amount David would have to pay for COBRA continuation coverage if his portion of the $300 cost to his employer under the 2009 Recovery Act was 65%.]

   d. $300. [This answer is incorrect. This is the amount David would have paid for his COBRA coverage prior to the Recovery Act.]

## EXAMINATION FOR CPE CREDIT

### Lesson 1

Determine the best answer for each question below. Then log onto our Online Grading Center at **OnlineGrading.Thomson.com** to record your answers.

1. James and June Smith are married and file jointly. Their total combined earned income for 2010 is $12,500. Calculate their total refundable "making work pay credit."

   a. $ 400.

   b. $ 775.

   c. $ 800.

   d. Do not select this answer choice.

2. In the example above, what is James and June's making work pay credit amount if they are eligible for the maximum credit amount for joint filers, but have a modified AGI of $200,000?

   a. $ 400.

   b. $ 775.

   c. $ 800.

   d. James and June do not receive any credit.

3. What is the amount of the earned income credit percentage for 2010 for a taxpayer with three or more children?

   a. 40%.

   b. 42%.

   c. 45%.

   d. 48%.

4. Which of the following statements best describes how the 2009 Recovery Act modifies the AGI phase-out rules for the modified Hope credit?

   a. Provides for an inflation adjustment of modified AGI threshold amounts for the 2009 tax year.

   b. Individuals filing separately must start to reduce their credit amount at modified AGI of $50,000.

   c. Individuals filing jointly must start to reduce their credit amount at modified AGI of $160,000.

   d. Do not select this answer choice.

5. Assuming all other qualifications are met, which of the following new homebuyers is eligible for the first-time homebuyer credit?

   a. Tom who has been renting an apartment in Dallas for the past four years owns a lake house in Austin. He is purchasing a new home on a golf course in Keller.

   b. Steve who owns a home in University Park which has been his principal residence for 15 years also owns a lake house in Austin. He is selling his home in University Park and purchasing a condo in Dallas.

   c. Scott and Katy, newlyweds, are purchasing their first home in Lakewood. Their modified AGI is $172,000.

   d. Do not select this answer choice.

6. Under the provisions of the 2009 Recovery Act, for a period not to exceed nine months, what is the amount of the “subsidy” an individual is entitled to receive toward payment of the monthly premium for COBRA continuation coverage if his or her employer’s monthly premium is $204?

   a. $0.

   b. $71.40.

   c. $132.60.

   d. $204.00.

# Lesson 2: Hiring Incentives to Restore Employment (HIRE) Act

### Learning Objectives

Completion of this lesson will enable you to:

- Determine the effects of the HIRE Act on payroll taxes, unemployed workers, retained workers, and Section 179 expensing limits.

### Overview

The HIRE Act (The Hiring Incentives to Restore Employment Act) was signed into law by the President on March 18, 2010.

## Payroll Tax Holiday in 2010 for Hiring Unemployed Workers

The Federal Insurance Contributions Act (FICA) imposes two taxes, the Old Age, Survivors and Disability Insurance (OASDI) tax and the Medicare Hospital Insurance (HI) tax. These taxes are imposed on employers for wages paid with respect to employment and on employees for wages received with respect to employment. The OASDI tax rate is 6.2% on wages up to an annually-adjusted “wage base” ($106,800 for 2010). The HI tax rate is 1.45% on all wages, regardless of amount. Under pre-Act law, the Social Security payroll tax wasn’t forgiven for employers who hired the unemployed.

Employers who hire members of certain targeted groups before September 2011 may claim a work opportunity credit (WOTC) equal to a percentage of up to $6,000 of first-year wages per employee, $12,000 for qualified veterans, and $3,000 for qualified summer youth employees. If the employee is a long-term family assistance recipient, the credit is a percentage of first- and second-year wages, up to $10,000 per employee.

**New Law:** The Act provides relief from the employer share of OASDI taxes for employers that hire unemployed workers. The relief applies to wages paid beginning on March 19, 2010 (the day after the enactment date), and ending on December 31, 2010. (IRC Sec. 3111(d), as amended by Act Sec. 101(a))

More specifically, the OASDI tax on employers doesn’t apply to wages paid by a qualified employer with respect to employment during the period beginning on March 19, 2010, and ending on December 31, 2010, of any qualified individual for services performed:

- In a trade or business of the qualified employer; or
- For a qualified employer that is tax-exempt under IRC Sec. 501(a), in furtherance of the activities related to the purpose or function on which the employer’s exemption is based. (IRC Sec. 3111(d)(1), as amended by Act Sec. 101(a))

**Observation:** The payroll tax holiday applies only to the 6.2% OASDI portion of the employer’s tax. It doesn’t apply to the 1.45% Medicare (HI) portion of the employer’s tax, nor to any part of the employee’s tax. It also doesn’t affect the self-employment tax paid by self-employed individuals.

**Observation:** The amount of tax forgiven per employee can't exceed $6,621.60, because the OASDI tax applies to only the first $106,800 of wages paid in 2010 ($106,800 × 6.2% = $6,621.60).

**Observation:** An employee need not work for a minimum number of hours in order for the employer to qualify for the payroll tax holiday. Thus, the holiday is available for wages paid to part-time employees.

**Observation:** The payroll tax holiday ends for wages paid after December 31, 2010. Thus, hiring an unemployed worker earlier in the year will increase the tax saving.

**Example:** On April 1, 2010, a qualified employer hires a qualified individual earning $90,000 per year. The employee continues working for the employer for the rest of 2010 (three-quarters of the year). The payroll tax holiday will save the employer $4,185 in OASDI tax ($90,000 × ¾ × 6.2%).

A *qualified employer* is any employer other than the U.S., a state, or a political subdivision of a state (i.e., a local government, or an instrumentality). (IRC Sec. 3111(d)(2)(A)) However, a public institution of higher education is a qualified employer even though it is a government instrumentality. (IRC Sec. 3111(d)(2)(B))

**Observation:** Thus, the payroll tax holiday applies to employers in the private and not-for-profit sectors. It doesn't apply to public-sector employers other than public institutions of higher education.

A *qualified individual* is anyone who:

1. Begins employment with a qualified employer after February 3, 2010, and before January 1, 2011.

   **Observation:** Although a qualified employee who begins work after February 3, 2010, can be eligible for the payroll tax holiday, only the employer's portion of OASDI on his wages paid with respect to employment after March 18, 2010 (the enactment date), will be forgiven.

2. Certifies by signed affidavit, under penalties of perjury, that he hasn't been employed for more than 40 hours during the 60-day period ending on the date the individual begins employment with the qualified employer.

   **Observation:** The IRS is developing a form employees can use to make the required statement.

3. Isn't employed to replace another employee of the qualified employer unless that other employee separated from employment voluntarily or for cause.

4. Isn't related to the qualified employer in a way that would disqualify him for the WOTC under IRC Sec. 51(i)(1). (IRC Sec. 3111(d)(3))

The Committee Report says an employer may qualify for the payroll tax holiday when it hires an otherwise qualified individual to replace one who was terminated for cause or due to other facts and circumstances, such as where a factory is closed due to lack of demand. When the factory reopens, the payroll tax holiday can be claimed both for rehiring old workers and hiring new workers. However, an employer who terminates an employee without cause in order to claim the payroll tax holiday for hiring the same or another employee doesn't qualify. An IRS news release confirms that new hires filling existing positions also qualify if the workers they are replacing left voluntarily or for cause.

**Observation:** Under item 4, above, there's no payroll tax holiday for hiring a relative such as the qualified employer's child or descendant of a child; a stepchild; sibling, stepbrother, or stepsister; parent or stepparent; niece, nephew, uncle or aunt; or in-laws.

If the qualified employer is:

- A corporation, an individual standing in any of the above relationships to anyone who owns, directly or indirectly, more than 50% in value of its outstanding stock, after applying the IRC Sec. 267(c) attribution rules, won't qualify.
- A noncorporate entity, an individual standing in any of the above relationships to anyone who owns, directly or indirectly, more than 50% of the capital and profits interests in the entity attribution rules, won't qualify.
- An estate or trust, a grantor, beneficiary, or fiduciary of the estate or trust, or an individual having any of the familial relationships described above to a grantor, beneficiary, or fiduciary of the estate or trust, won't qualify.

An individual unrelated to the qualified employer who is the employer's dependent because he has the same principal place of abode and is a member of the employer's household won't qualify. If the qualified employer is a corporation, an individual who is a dependent of anyone who owns, directly or indirectly, more than 50% in value of the outstanding stock, won't qualify. A dependent of a grantor, beneficiary, or fiduciary of an estate or trust that is a qualified employer won't qualify.

**Observation:** Services performed outside the U.S. by a citizen or resident of the U.S. as an employee of an American employer are "covered employment" for FICA tax purposes. Nothing in the statute would exclude those employees from qualifying for the payroll tax holiday.

The payroll tax holiday doesn't apply for eligible wages paid during the first calendar quarter of 2010. Instead, the amount by which the qualified employer's OASDI tax for wages paid during the first calendar quarter of 2010 would have been reduced if the payroll tax holiday had been in effect for that quarter is treated as a payment against the qualified employer's OASDI tax for the second calendar quarter of 2010. (IRC Sec. 3111(d)(5)(B)) The payment is treated as made on the date when the employer's second-quarter OASDI tax is due.

**Observation:** Most employers report employment taxes quarterly on Form 941 (Employer's Quarterly Federal Tax Return). The rule providing that the payroll tax holiday doesn't apply for wages paid during the first quarter will give the IRS time to issue guidance about the payroll tax holiday and will give employers time to adjust their payroll systems accordingly. Employers won't lose out, because the amount of first-quarter wages that would have been forgiven will be allowed as a credit for the second quarter. The IRS revised Form 941 for the second quarter of 2010.

A qualified employer may elect, in the manner that the IRS requires, not to have the payroll tax holiday apply. (IRC Sec. 3111(d)(4)) Unless the employer elects out of the payroll holiday, wages paid or incurred to a qualified individual won't qualify for the WOTC during the one-year period beginning on the date that the qualified employer hired the individual. (IRC Sec. 51(c)(5)) The Committee Report indicates that the election can be made on an employee-by-employee basis.

**Observation:** The WOTC is in many cases more valuable than the payroll tax holiday, especially for low-wage employees, because it is generally 40% of "qualified first-year wages" of up to $6,000, for maximum credit of $2,400 per worker. The payroll tax holiday is equal to 6.2% of wages, and applies only to wages paid through December 31, 2010. However, the WOTC is harder to qualify for, because the employee must be certified by an agency as belonging to a targeted group. The main qualification for the payroll tax holiday is that the employee has been unemployed for 60 days, and the employee's affidavit is sufficient for this purpose.

Effective for compensation paid after March 18, 2010, the Act provides a railroad retirement tax holiday that is similar in many respects to the OASDI tax holiday. (IRC Sec. 3221(c), as amended by Act Sec. 101(d))

## New Up-to-$1,000 Credit for Each "Retained Worker"

For any tax year ending after March 18, 2010, the Act provides an up-to-$1,000 credit for "retained workers." (Act Sec. 102) A retained worker is defined as any qualified individual, as defined for purposes of the payroll tax holiday:

1. Who was employed by the taxpayer on any date during the tax year,
2. Who was so employed by the taxpayer for a period of not less than 52 consecutive weeks, *and*
3. Whose wages (as defined in IRC Sec. 3401(a)) for that employment during the last 26 weeks of the period (described in item 2 above) equaled at least 80% of the wages for the first 26 weeks of that period. (Act Sec. 102(b))

**Observation:** The definition of wages for withholding purposes in IRC Sec. 3401(a) generally includes all remuneration (other than fees paid to a public official) for services performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash. Thus, compensation that isn't subject to withholding, such as certain fringe benefits, wouldn't be included as wages for purposes of the up-to-$1,000 credit for retained workers. Also, wages paid to certain types of employees who are exempt from income tax withholding under IRC Sec. 3401(a) wouldn't qualify as wages for purposes of the up-to-$1,000 credit. The exemptions from withholding provided in IRC Sec. 3401(a) include wages paid to certain agricultural labor, domestics working in private homes, certain employees working in foreign countries (if the employer is required to withhold on the wages under foreign law), etc.

Under Act Sec. 102(a), for any tax year ending after March 18, 2010, the current year business credit determined under IRC Sec. 38(b) for the tax year is *increased*, for each retained worker (as defined above) with respect to which the 52-consecutive-week requirement in 2, above, is *first* satisfied during the tax year, by the *lesser* of:

- $1,000; or
- 6.2% of the wages (as defined for income tax withholding in IRC Sec. 3401(a)) paid by the taxpayer to the retained worker during the 52-consecutive-week period. (Act Sec. 102(a))

**Observation:** If a retained worker's wages during the 52-consecutive-week period exceed $16,129.03, the increase to the current year business credit for that retained worker will be $1,000.

**Observation:** Since the increase to the current year business credit under the above rules applies in the tax year in which the 52-consecutive-week test is *first* satisfied, the increase to the current year business credit with respect to each retained employee only occurs in one tax year (i.e., the tax year in which the 52-consecutive-week test is first satisfied by a particular employee).

**Observation:** For an employer using the calendar year as its tax year, the increase to the current year business credit will be claimed on the employer's 2011 tax return.

**Example 1:** ABC Corp., a taxpayer using the calendar year as its tax year, hires Earl, a retained worker, on February 15, 2010. The 52-consecutive-week requirement is first satisfied in the 2011 tax year if Earl works for ABC until February 14, 2011. His wages for the 52-consecutive-week period are $30,000. In that case, on its 2011 tax return, ABC's current year business credit will be increased by $1,000 for Earl.

**Observation:** Certain fiscal year taxpayers may have to claim the increase to the current year business credit on tax returns for two tax years on an employee-by-employee basis.

**Example 2:** The facts are the same as in Example 1 except that ABC Corp. uses a fiscal year beginning on December 1 and ending on November 30 as its tax year. ABC Corp. also hires Carol (a retained worker) on December 31, 2010, and she is still working for ABC on December 30, 2011. Carol's wages for the 52-consecutive-week period are $52,000.

The 52-consecutive-week requirement is first satisfied with respect to Earl on February 14, 2011, and with respect to Carol on December 30, 2011. Thus, ABC can claim the $1,000 increase to the current year business credit for Earl on its tax return for the fiscal year ending on November 30, *2011* and the $1,000 increase for Carol on its tax return for the fiscal year ending on November 30, *2012.*

**Example 3:** The facts are the same as in Example 2 except that Earl quits working for ABC on January 30, 2011. Since he only worked for ABC for 50 consecutive weeks, the 52-consecutive-week requirement isn't satisfied for Earl, and ABC can't claim the up-to-$1,000 credit for him.

**Observation:** Presumably, the IRS will soon issue a form for claiming the $1,000 increase to the current year business credit for the retention of certain newly-hired employees as it has for other employee retention credits such as the Midwestern Disaster Area employee retention credit that is claimed on Form 5884-A and on Form 3800.

**Note:** An employer will need to keep careful records with respect to each employee hired after February 3, 2010, and before January 1, 2011, so that it can prove that each employee for which it claims the up-to-$1,000 increase to the current year business credit meets the definition of a retained worker.

**Observation:** Presumably, the increase to the current year business credit under Act Sec. 102 occurs *before* the application of any of the limitations under IRC Sec. 38(c) that apply to the general business credit as determined under IRC Sec. 38(a)(2). Thus, the up to $1,000 increase to the current year business credit is subject to the rules that, under IRC Sec. 38, can prevent some taxpayers from enjoying full use of the credit to reduce their tax liabilities in the tax year that the credit is claimed. For example, the increase to the current year business credit under Act Sec. 102 won't be allowed to offset any of a taxpayer's alternative minimum tax (AMT), and will be limited in its offset of a taxpayer's regular income tax.

No portion of the unused business credit under IRC Sec. 38 for any tax year that is attributable to the up-to-$1,000 increase in the current year business credit under Act Sec. 102 can be carried to a tax year *beginning* before March 18, 2010. (Act Sec. 102(c))

**Observation:** A one-year carryback generally applies to unused business credits under IRC Sec. 39(a)(1). However, Act Sec. 102(c) prevents a taxpayer from carrying back any portion of an unused business credit that is attributable to the up-to-$1,000 increase of the current year business credit to a tax year beginning *before* March 18, 2010. Since a taxpayer using the calendar year as its tax year is only entitled to the up-to-$1,000 increase to the current year business credit in 2011 (see above), the effect of the rule in Act Sec. 102(c) is that a calendar year taxpayer can't carry back any portion of the unused business credit that is attributable to the up-to-$1,000 increase to 2010 (a tax year that began before March 18, 2010). Thus, a calendar year taxpayer isn't allowed the one-year carryback (that would be allowed under IRC Sec. 39(a)(1)(A) but for the rule in Act Sec. 102(c)) of any portion of any unused business credit that is attributable to the up-to-$1,000 increase to the current year business credit under Act Sec. 102.

**Observation:** The transitional rule in Act Sec. 102(c) was necessary because the transitional rule in IRC Sec. 39(d) (generally providing that no part of any unused current business credit attributable to a component credit can be carried back to any tax year before the first tax year that the component credit was allowable) is limited to the credits *listed* under IRC Sec. 38(b)), and the increase to the current year business credit under Act Sec. 102 isn't listed in IRC Sec. 38(b).

**Observation:** There are no special *carryforward* provisions that apply to the up-to-$1,000 increase to the current year business credit for retained workers. Thus, presumably, any portion of the general business credit that is attributable to the increase to the current year business credit will be subject to the 20-year carryforward limitations applicable to current year unused business credits.

## Section 179 Expensing Limits Boosted for 2010

Generally, taxpayers can elect to treat the cost of any IRC Sec. 179 property placed in service during the tax year as an expense which is not chargeable to capital account, and any cost so treated is allowed as a deduction for the tax year in which the section 179 property is placed in service.

For tax years beginning in 2008 and 2009, the maximum amount that could be expensed under IRC Sec. 179 was $250,000, and the maximum deductible expense was reduced (i.e., phased out, but not below zero) by the amount by which the cost of IRC Sec. 179 property placed in service during tax year 2008 or 2009 exceeded $800,000. The $250,000 and $800,000 amounts were not adjusted for inflation.

Under pre-Act law, for tax years beginning in 2010, the maximum amount that could be expensed under IRC Sec. 179, was $134,000, and the maximum deductible expense had to be reduced (i.e., phased out, but not below zero) by the amount by which the cost of IRC Sec. 179 property placed in service during the 2010 tax year exceeded $530,000 (i.e., the beginning-of-phase-out amount). The 2010 amounts reflected statutory inflation adjustments.

For tax years beginning after 2010, the maximum expensing amount under IRC Sec. 179 is $25,000, the beginning-of-phase-out amount is $200,000, and neither amount is adjusted for inflation.

Qualifying property for purposes of the IRC Sec. 179 expensing election is depreciable tangible personal property purchased for use in the active conduct of a trade or business, including “off-the-shelf” computer software placed in service in tax years beginning before 2011.

**New Law:** For tax years beginning *after 2007 and before 2011,* the Act provides that:

- The dollar limitation on the IRC Sec. 179 expensing deduction is $250,000,
- The reduction in the dollar limitation (beginning-of-phase-out amount) starts to take effect when property placed in service in a tax year exceeds $800,000, and
- Neither the dollar limitation nor the beginning-of-phase-out amount is adjusted for inflation. (IRC Sec. 179(b), as amended by Act Sec. 201(a)).

Additionally, the increase in dollar limitation amounts and no-inflation-adjustment rule for 2008 and 2009 are removed. (Act Sec. 201(a)(3))

Thus, the Act increases for one year (2010) the amount a taxpayer can expense under IRC Sec. 179. The maximum amount a taxpayer can expense for a tax year beginning in 2010 is $250,000 of the cost of qualifying property placed in service for that tax year. The $250,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during 2010 exceeds $800,000.

**Observation:** Since the $250,000 and $800,000 limitation amounts and no-inflation-adjustment rule applied under pre-Act law for tax years beginning in 2008 and 2009, the Act both extends those limitation and phase-out amounts to tax years beginning in 2010 and eliminates the inflation-adjustment rule which applied for tax years beginning in 2010 under pre-Act law.

**Example:** In 2010, Midcorp, a calendar-year taxpayer, places into service IRC Sec. 179 property with a cost of $660,000. It can elect to expense $250,000 of the cost (there’s no phase-out because the cost of IRC Sec. 179 property placed in service during the year does not exceed $800,000, the beginning-of-phase-out amount for 2010).

**Observation:** For property placed in service in tax years beginning in 2010, the IRC Sec. 179 expensing deduction phases out completely only when the cost of the property exceeds $1,050,000 ($800,000 (beginning-of-phase-out amount) + $250,000 (dollar limitation)). This is the same limit that applied under pre-Act law for property placed in service in 2008 or 2009.

## SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers with the correct answers in the following section.

8. Which of the following is correct regarding the payroll tax holiday included in the HIRE Act that was signed into law by the President on March 18, 2010?

    a. The payroll tax holiday is available only to full-time newly-hired employees whom an employer hires after March 18, 2010.

    b. The payroll tax holiday forgives the employer-portion of the OASDI tax and Medicare tax for newly-hired unemployed workers.

    c. There is a limit to the amount of tax forgiven under the payroll tax holiday for employers due to the OASDI tax limit on wages.

    d. The payroll tax holiday is available to qualified employers for all of 2010.

9. Which of the following employees would qualify the employer for the payroll tax holiday under the HIRE Act of 2010?

    a. David is terminated from Sunset Productions on February 15, 2010, without cause. On March 1, 2010, Kevin is hired to replace David at Sunset Productions.

    b. Steven is hired by KLB Industries, a qualified employer, on February 15, 2010. Steven was terminated from his previous employer on December 1, 2009, but worked 20 hours of seasonal work in the last week of December 2009.

    c. Sarah, a previously unemployed worker, is hired by her brother to work in his sandwich shop part-time on April 1, 2010.

    d. Stacy, a previously unemployed worker, is hired as a secretary at Willowsby Learning Center on January 15, 2010.

10. In which of the following situations could Parker Corporation take the maximum amount of payroll tax credit in 2010 under the retained worker credit included in the HIRE Act of 2010?

    a. Aubrey was hired by Parker Corporation in November 2009 with an annual salary of $45,000. She worked for Parker for all of 2010.

    b. David begins working for the company on April 15, 2010, with an annual salary of $35,000.

    c. Tina, a long-time employee of Parker Corporation, decided to go part-time with the company three years ago when her daughter was born. In 2010, she earned $15,000 at the company.

    d. Ed, a five-year employee of Parker, took a pay cut of 25% in May 2010, instead of being laid off for the remaining months of 2010.

## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

8. Which of the following is correct regarding the payroll tax holiday included in the HIRE Act that was signed into law by the President on March 18, 2010? **(Page 18)**

   a. The payroll tax holiday is available only to full-time newly-hired employees whom an employer hires after March 18, 2010. [This answer is incorrect. An employee need not work a minimum number of hours in order for the employer to qualify for the payroll tax holiday. Thus, the holiday is available for wages paid to part-time employees.]

   b. The payroll tax holiday forgives the employer-portion of the OASDI tax and Medicare tax for newly-hired unemployed workers. [This answer is incorrect. The payroll tax holiday applies only to the 6.2% OASDI portion of the employer's tax. It doesn't apply to the 1.45% Medicare (HI) portion of the employer's tax, nor to any part of the employee's tax.]

   **c. There is a limit to the amount of tax forgiven under the payroll tax holiday for employers due to the OASDI tax limit on wages. [This answer is correct. Although there is no limit on the total amount of an employer's OASDI tax that may be forgiven under this provision, the amount of tax forgiven for each employee can't exceed $6,621.60. This is because the OASDI tax applies only to the first $106,800 of wages paid in 2010. ($106,800 × 6.2% = $6,621.60)]**

   d. The payroll tax holiday is available to qualified employers for all of 2010. [This answer is incorrect. The payroll tax holiday doesn't apply for wages paid during the first calendar quarter of 2010 and ends for wages paid after December 31, 2010. Thus, hiring an unemployed worker earlier in the year—but after February 3, 1010—will increase the tax savings to the employer.]

9. Which of the following employees would qualify the employer for the payroll tax holiday under the HIRE Act of 2010? **(Page 18)**

   a. David is terminated from Sunset Productions on February 15, 2010, without cause. On March 1, 2010, Kevin is hired to replace David at Sunset Productions.
   [This answer is incorrect. An employer won't qualify for the payroll tax holiday under the HIRE Act of 2010 if an employee is terminated without cause in order to claim the payroll tax holiday for hiring the same or another employee. (Committee Report, see ¶ 5401)]

   **b. Steven is hired by KLB Industries, a qualified employer, on February 15, 2010. Steven was terminated from his previous employer on December 1, 2009, but worked 20 hours of seasonal work in the last week of December 2009. [This answer is correct. An employee is a qualified employee is he begins employment after February 3, 2010, and certifies by signed affidavit that he hasn't been employed for more than 40 hours during the 60-day period ending on the date the individual begins employment with the qualified employer. Although Steven did work in the previous 60-day period, his time worked did not exceed 40 hours, thus making him eligible.]**

c. Sarah, a previously unemployed worker, is hired by her brother to work in his sandwich shop part-time on April 1, 2010. [This answer is incorrect. Sarah is not eligible to be a qualified employee under the HIRE Act of 2010 for her brother's sandwich shop since she is related to the qualified employer. There is no payroll tax holiday for hiring the qualified employer's son, daughter, or descendant of either; stepson or stepdaughter; brother, sister, stepbrother, or stepsister; father, mother or ancestor of either; stepfather or stepmother; son or daughter of brother or sister; brother or sister of father or mother, daughter-in-law, father-in-law, mother-in-law, brother-in-law or sister-in-law.]

d. Stacy, a previously unemployed worker, is hired as a secretary at Willowsby Learning Center on January 15, 2010. [This answer is incorrect. A qualified employer is not eligible for the payroll tax holiday if the employee is hired before February 3, 2010.]

10. In which of the following situations could Parker Corporation take the maximum amount of payroll tax credit in 2010 under the retained worker credit included in the HIRE Act of 2010? **(Page 20)**

**a. Aubrey was hired by Parker Corporation in November 2009 with an annual salary of $45,000. She worked for Parker for all of 2010. [This answer is correct. Aubrey's wages are eligible for the maximum credit under the retained worker credit for Parker Corporation of $1,000, since she was employed by the taxpayer on any date during the tax year for 52 consecutive weeks and her wages are high enough that she maximizes out on the credit for the company.]**

b. David begins working for the company on April 15, 2010, with an annual salary of $35,000. [This answer is incorrect. Since David began working for the company on April 15, 2010, his consecutive 52-week time period would not end until April 14, 2011. Parker Corporation could not take a payroll tax credit for David in 2010 at all, but would be eligible for one in 2011.]

c. Tina, a long-time employee of Parker Corporation, decided to go part-time with the company three years ago when her daughter was born. In 2010, she earned $15,000 at the company. [This answer is incorrect. To maximize the retained worker's credit, a worker's wages during the 52-consecutive-week period need to exceed $16,129.03. Since Tina earned only $15,000 with the company in 2010, the credit eligible to Parker Corporation would be $930 (6.2% of the eligible wages).]

d. Ed, a five-year employee of Parker, took a pay cut of 25% in May 2010, instead of being laid off for the remaining months of 2010. [This answer is incorrect. Any employee whose wages for employment during the last 26 weeks of the period did not equal at least 80% of the wages for the first 26 weeks of that period is not eligible for the retained worker's credit for the employer.]

## EXAMINATION FOR CPE CREDIT

### Lesson 2

Determine the best answer for each question below. Then log onto our Online Grading Center at **OnlineGrading.Thomson.com** to record your answers.

7. Redhouse Manufacturing hired Ben, a previously unemployed worker, to be their IT manager on April 1, 2010. Ben's yearly salary is $75,000. How much will Redhouse Manufacturing save as part of the payroll tax holiday on Ben's salary in 2010?

   a. $2,325.

   b. $3,487.50.

   c. $4,650.

   d. $6,621.60.

8. Which of the following would be a qualified employer, eligible for the payroll tax holiday under the HIRE Act of 2010?

   a. A state-funded college.

   b. A town's parks and recreation department.

   c. A local school district.

   d. The Internal Revenue Service.

9. Which of the following is true about an employer's rights in relation to the payroll tax holiday?

   a. An employer is eligible for the payroll tax holiday and the work opportunity credit.

   b. Employers can only claim the payroll tax holiday for new employees within a specific target group.

   c. Only work performed by U.S. citizens within the U.S. qualifies for the payroll tax holiday for employers.

   d. Employers can take a credit for the amount of first-quarter eligible wages in the second quarter of 2010.

10. Under the retained worker credit within the HIRE Act of 2010, which of the following employees would qualify as a retained employee for ABC Corporation?

    a. Lynn, a 15-year employee of ABC Corporation, decided to go part-time at the company on March 1, 2010, for the remainder of the year.

    b. Phillip was hired by ABC Corporation in November 2009. In February 2010, it was determined that Phillip's work was not sufficient and he was demoted, with a 30% pay decrease. Paul decided to stay with ABC for the rest of 2010.

    c. Frank was hired by ABC Corporation in March 2010. He worked all of 2010 for ABC and received a 1% raise from the company in March 2011.

    d. Mark was hired by ABC Corporation in May 2010. His employment did not work out and he was terminated for cause on November 15, 2010.

11. For tax years beginning in 2010, which is the maximum amount that can be expensed for Section 179 expenses under the HIRE Act of 2010?

    a. $25,000.

    b. $200,000.

    c. $250,000.

    d. $800,000.

# Lesson 3: 2010 Health Care Legislation

### Learning Objectives

Completion of this lesson will enable you to:

- Define those subject to the penalty for no health insurance, those eligible for a tax credit and those subject to qualified health plans as these terms apply to the Health Care Act.
- Recognize the changes to health care legislation due to the Health Care Act, including the health coverage excise tax, "free choice" vouchers, the health insurance credit for small employers and extension of health benefits for adult children.

## Adoption Credit and Exclusion for Employer-provided Assistance Expanded

An individual can claim a tax credit for qualified adoption expenses, which are reasonable and necessary adoption fees, court costs, attorney fees, and other expenses that are directly related to and the principal purpose of which is the taxpayer's legal adoption of an eligible child. The total amount that may be taken as a credit for all tax years for the adoption of a child is $12,170 for 2010. This maximum credit is allowed for the adoption of a child with special needs regardless of whether the taxpayer has qualified adoption expenses, reduced by aggregate adoption expenses for the tax year the adoption becomes final and all earlier tax years. The credit begins to phase out if the taxpayer's adjusted gross income (AGI), as modified in a special way, exceeds $182,520 for 2010, and is fully eliminated when it reaches $222,520 for 2010 of modified AGI.

An employee may exclude amounts paid or expenses incurred by his employer for qualified adoption expenses connected with the employee's adoption of a child under an adoption assistance program. Similar maximums and phase-out thresholds apply for the employer-provided adoption assistance exclusion as for the adoption credit.

For tax years after 2010, under the Economic Growth and Tax Relief Reconciliation Act of 2001 sunset provisions, the regular adoption credit and the employer-provided adoption assistance exclusion will not apply; the credit for special needs adoptions will be reduced to a maximum credit of $6,000. The credit phase-out range will revert to the pre-EGTRRA levels (i.e., a ratable phase-out between modified AGI between $75,000 and $115,000). The credit will be allowed only to the extent the individual's regular income tax liability exceeds his tentative minimum tax, determined without regard to the minimum foreign tax credit.

**New Law:** For tax years beginning after December 31, 2009, the maximum adoption credit is increased to $13,170 per eligible child (a $1,000 increase) for both nonspecial needs adoptions and special needs adoptions. (IRC Sec. 36C, as amended and redesignated by Health Care Act Sec. 10909) The adoption credit maximum dollar limit and phase-out are adjusted for inflation in tax years beginning after December 31, 2010. (IRC Sec. 36C(h)) The adoption credit is also made refundable, by redesignating the IRC Sec. 23 adoption credit provisions as IRC Sec. 36C and moving the redesignated provision from subpart A of part IV of subchapter A of chapter 1 of the Code (the nonrefundable personal credits) to subpart C of part IV of subchapter A of chapter 1 (the refundable credits). (Health Care Act Sec. 10909(b)(1)(B))

Any excess of the adoption credit over the income tax is taken into account as a negative amount of tax in computing a taxpayer's tax deficiency. (IRC Sec. 6211(b)(4)(A), as amended by Health Care Act Sec. 10909(b)(2)(N))

For tax years beginning after December 31, 2009, the maximum exclusion for employer-provided adoption assistance also is increased to $13,170 per eligible child (a $1,000 increase). (IRC Sec. 137, as amended by Health Care Act Sec. 10909(a)) The maximum exclusion and phase-out are adjusted for inflation in tax years beginning after December 31, 2010. (IRC Sec. 137(f))

The EGTRRA sunset for the adoption credit and the exclusion for employer-provided adoption assistance are delayed for one year. (Health Care Act Sec. 10909(c))

## Employer Health Plans—Dependent Coverage of Children under Age 27

Under IRC Sec. 106, employees may exclude from gross income the value of employer-provided health coverage under an accident or health plan. The exclusion applies to coverage for personal injuries or sickness for employees (including retirees), their spouses and their dependents. In addition, under IRC Sec. 105(b), any reimbursements under an accident or health plan for medical care expenses for employees (including retirees), their spouses, and their dependents (as defined in IRC Sec. 152, i.e., a qualifying child or qualifying relative) generally are excluded from gross income. For this purpose, a "child" means an individual who is the taxpayer's son, daughter, stepson, stepdaughter or eligible foster child (i.e., an individual who is placed with the taxpayer by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction). Under pre-Act law, among the requirements for a child to be a qualifying child of a taxpayer under IRC Sec. 152(c) was that the child had to be under age 19 (or under age 24 in the case of a full-time student). No age limit applies for individuals who are totally and permanently disabled at any time during the calendar year.

Self-employed individuals can deduct the cost of health insurance for themselves and their spouses and dependents.

A voluntary employees' beneficiary association (VEBA) is a tax-exempt entity that is a part of a plan providing life, sick or accident benefits to its members or their dependents or designated beneficiaries if no part of the net earnings of the association inures (other than through the payment of life, sick, accident or other benefits) to the benefit of any private shareholder or individual.

A qualified pension or annuity plan can establish and maintain a separate account to provide for the payment of sickness, accident, hospitalization, and medical expenses for retired employees, their spouses and their dependents (i.e., a "401(h) account").

**New Law:** Effective on March 30, 2010 (the enactment date of the Reconciliation Act), the general exclusion for reimbursements for medical care expenses under an employer-provided accident or health plan is extended to any child of an employee who hasn't attained age 27 as of the end of the tax year. (IRC Sec. 105(b), as amended by Reconciliation Act Sec. 1004(d)) This change is also intended to apply to the exclusion for employer-proved coverage under an accident or health plan for injuries or sickness for such a child. (Committee Report)

A parallel change is made for VEBAs (IRC Sec. 501(c)(9)), and for IRC Sec. 401(h) accounts. (IRC Sec. 401(h)) IRC Sec. 162(l) is similarly amended to allow self-employed individuals to take a deduction for any child of the taxpayer who has not attained age 27 as of the end of the tax year. (IRC Sec. 162(l)(1)(D))

**Observation:** There is no requirement for a plan or issuer to provide health insurance coverage for anyone, including dependents. But if coverage is provided for dependent children, then, under the 2010 Health Care Act, the coverage must continue until the children turn 26.

**Observation:** Because PHSA §2714 (above) is treated as if included in the Code, the sponsor of a plan that provides dependent coverage is subject to the IRC Sec. 4980D excise tax if the plan fails to offer participants the option to cover their young adult children up until age 26.

Nothing in the rule above requires a health plan or a health insurance issuer to make coverage available to a child *of a child* receiving dependent coverage. (PHSA §2714(a))

**Observation:** Thus, even if a group health plan participant's adult child (i.e., who is under age 26) is covered under the plan under the requirement described above, a *child* of that adult child would not *have to be* covered under that requirement. Whether, and under what conditions, a participant's grandchild *may be* covered under the plan would depend on the plan's terms.

**Observation:** If an S corporation pays accident and health insurance premiums (under a plan "established" by the S corporation) on behalf of a more-than-2% shareholder who is also its employee and who must include the value of the premiums in his gross income, the shareholder is permitted to deduct the cost of the premiums paid on his behalf to the extent allowed under the IRC Sec. 162(l) rules. Thus, the expanded definition of children for whom the self-employed deduction for health insurance premiums may be claimed also applies to more-than-2% S corporation shareholders entitled to claim the deduction.

**Effective:** Plan years beginning on or after September 23, 2010. (2010 Health Care Act §1004(a))

## Health Insurance Credit for Small Employers

Under pre-Act law there is no tax credit for employers that provide health coverage for their employees.

**New Law:** For tax years beginning after December 31, 2009, a tax credit is provided for an eligible small employer for nonelective contributions to purchase health insurance for its employees. (IRC Sec. 45R, as added by Health Care Act Sec. 1421, as amended by Health Care Act Sec. 10105) An eligible small employer (ESE) for this purpose generally is an employer with no more than 25 full-time equivalent employees ("FTEs") employed during its tax year, and whose employees have annual full-time equivalent wages that average no more than $50,000. (IRC Sec. 45R(d)) However, the full amount of the credit is available only to an employer with 10 or fewer FTEs and whose employees have average annual full-time equivalent wages from the employer of less than $25,000. (IRC Sec. 45R(c))

The contributions must be provided under an arrangement that requires the eligible small employer to make a nonelective contribution on behalf of each employee who enrolls in certain defined qualifying health insurance offered to employees by the employer equal to a uniform percentage (not less than 50%) of the premium cost of the qualifying health plan. (IRC Sec. 45R(d)(4))

The credit is only available to offset actual tax liability and is claimed on the employer's tax return. The credit is not payable in advance to the taxpayer or refundable. Thus, the employer must pay the employees' premiums during the year and claim the credit at the end of the year on its income tax return (Committee Report). The credit is a general business credit, and can be carried back for one year and carried forward for 20 years. (IRC Sec. 38(b), IRC Sec. 39(a)) The credit is available for tax liability under the alternative minimum tax. (IRC Sec. 38(c)(4)(B)(vi))

The credit is initially available for any tax year beginning in 2010, 2011, 2012, or 2013. Qualifying health insurance for claiming the credit for this first phase of the credit is health insurance coverage within the meaning of IRC Sec. 9832, which is generally health insurance coverage purchased from an insurance company licensed under state law.

For tax years beginning in years after 2013, the credit is only available to an eligible small employer that purchases health insurance coverage for its employees through a state exchange and is only available for a maximum coverage period of two consecutive tax years beginning with the first year in which the employer or any predecessor first offers one or more qualified plans to its employees through an exchange.

The credit is equal to the lesser of the following two amounts multiplied by an applicable tax credit percentage: (1) the amount of contributions the ESE made on behalf of the employees during the tax year for the qualifying health coverage and (2) the amount of contributions that the employer would have made during the tax year if each employee had enrolled in coverage with a small business benchmark premium. (IRC Sec. 45R(b)) To calculate the contributions under the second of these two amounts, the benchmark premium is multiplied by the number of employees enrolled in coverage and then multiplied by the uniform percentage that applies for calculating the level of coverage selected by the employer. (Committee Report)

The applicable percentage is 35% for tax years beginning in after 2009 and before 2014. It is 50% for tax years beginning after 2013. (IRC Sec. 45R(b))

The credit is reduced for employers with more than 10 FTEs but not more than 25 FTEs. It is also reduced for an employer for whom the average wages per employee is between $25,000 and $50,000. (IRC Sec. 45R(c))

Tax-exempt 501(c) organizations are allowed the credit in a lesser amount against certain payroll taxes. (IRC Sec. 45R(f))

The credit reduces the employer's deduction under IRC Sec. 162 for contributions. (IRC Sec. 45R(e)(5))

Aggregation rules apply in determining the employer. (IRC Sec. 45R(b))

Self-employed individuals, including partners and sole proprietors, 2% shareholders of an S corporation, and 5% owners of the employer (within the meaning of IRC Sec. 416(i)(1)(B)(i)) are not treated as employees for purposes of this credit. Any employee with respect to a self employed individual is not an employee of the employer for purposes of this credit if the employee is not performing services in the trade or business of the employer. Thus, the credit is not available for a domestic employee of a sole proprietor of a business. There is also a special rule to prevent sole proprietorships from receiving the credit for the owner and their family members. (IRC Sec. 45R(e)(1); Committee Report)

## Codification of Economic Substance Doctrine and Penalty Imposition

Under pre-Act law courts generally denied claimed tax benefits if the transaction that gave rise to those benefits lacked economic substance independent of U.S. federal income tax considerations. But there was a lack of uniformity regarding the proper application of the economic substance doctrine. Some courts applied a test that required a taxpayer to establish the presence of both economic substance (i.e., the objective component) and business purpose (i.e., the subjective component) in order for the transaction to survive judicial scrutiny. Some courts applied a narrower approach and concluded that either was sufficient to respect the transaction. A third approach regarded economic substance and business purpose as factors to be considered in determining whether a transaction had any practical economic effects other than the creation of tax benefits.

**New Law:** For transactions entered into after March 30, 2010, and for underpayments, understatements, and refunds and credits attributable to transactions entered into after March 30, 2010, the application of the economic substance doctrine is clarified and enhanced by way of a new uniform definition of economic substance. In the case of any transaction to which the economic substance doctrine is relevant, the transaction is treated as having economic substance only if—apart from federal income tax effects—(1) the transaction changes in a meaningful way the taxpayer’s economic position; and (2) the taxpayer has a substantial purpose for entering into such transaction. A transaction must satisfy both tests in order for it to be treated as having economic substance. (IRC Sec. 7701(o)(1), as amended by Reconciliation Act Sec. 1409(a)) The economic substance doctrine is defined as the common law doctrine under which tax benefits under subtitle A with respect to a transaction aren’t allowed if the transaction doesn’t have economic substance or lacks a business purpose. (IRC Sec. 7701(o)(5)(A)) New IRC Sec. 7701(o) doesn’t apply to personal transactions of individuals, only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income. (IRC Sec. 7701(o)(5)(B))

Without a trade or business or an activity engaged in for the production of income, a taxpayer can’t deduct depreciation, amortization or business investment credits. But absent a trade or business or activity for profit, the economic substance doctrine won’t apply to an individual’s personal transactions (e.g., whether he buys a home and qualifies for an interest deduction; adopts a child and qualifies for an adoption credit; or marries or divorces and changes his filing status).

The Reconciliation Act clarifies that a taxpayer’s nonfederal-income-tax purpose for entering into a transaction (the second prong in the analysis) must be “substantial.” Any state or local income tax effect which is related to a federal income tax effect is treated in the same manner as a federal income tax effect. (IRC Sec. 7701(o)(3)) A purpose of achieving a favorable accounting treatment for financial reporting purposes isn't taken into account as a nonfederal-income-tax purpose if the origin of the financial accounting benefit is a reduction of federal income tax. (IRC Sec. 7701(o)(4))

While it's clear that the profit potential must be more than a nominal or insignificant amount, determining what is "substantial" is left to be worked out by the IRS and the courts. Since there is no instructive precedent or guidance, this may be problematic for taxpayers.

A taxpayer may rely on factors other than profit potential to demonstrate that a transaction results in a meaningful change in the taxpayer's economic position or that the taxpayer has a substantial nonfederal-income-tax purpose for entering into the transaction. New IRC Sec. 7701(o) doesn't require or establish a minimum return that will satisfy the profit potential test. But, if a taxpayer relies on a profit potential, the present value of the reasonably expected pre-tax profit must be substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected ("the pre-tax profit to tax benefit ratio test"). (IRC Sec. 7701(o)(2)(A)) Fees and other transaction expenses are taken into account as expenses in determining pre-tax profit. The IRS is to issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases. (IRC Sec. 7701(o)(2)(B))

The determination of whether the economic substance doctrine is relevant to a transaction is made in the same manner as if new IRC Sec. 7701(o) had never been enacted. (IRC Sec. 7701(o)(5)(C)) Thus, the provision doesn't change present law standards in determining when to utilize an economic substance analysis. The Committee Report notes that leasing transactions, like all other types of transactions, will continue to be analyzed in light of all the facts and circumstances. The fact that a transaction meets the requirements for specific treatment under any Code provision isn't determinative of whether a transaction or series of transactions of which it is a part has economic substance. A court's ability to aggregate, disaggregate, or otherwise recharacterize a transaction when applying the doctrine isn't altered. (Committee Report)

The provision isn't intended to alter the tax treatment of certain basic business transactions that, under long-standing judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages. Among these basic transactions are:

1. The choice between capitalizing a business enterprise with debt or equity;

2. A U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment;

3. The choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C; and

4. The choice to utilize a related-party entity in a transaction if the arm's length standard of IRC Sec. 482 and other applicable concepts are satisfied. (Committee Report)

For underpayments attributable to transactions entered into after March 30, 2010, a new strict liability penalty under IRC Sec. 6662 applies for an underpayment attributable to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance (as defined in IRC Sec. 7701(o)), or failing to meet the requirements of any similar rule of law. (IRC Sec. 6662(b)(6), as amended by Reconciliation Act Sec. 1409(b)) It is intended that the penalty apply to a transaction the tax benefits of which are disallowed as a result of the application of the similar factors and analysis that is required under the provision for an economic substance analysis, even if a different term is used to describe the doctrine. (Committee Report) The penalty rate is 20% (increased to 40% if the taxpayer doesn't adequately disclose the relevant facts affecting the tax treatment in the return or a statement attached to the return). (IRC Sec. 6662(i)(1)) An amended return or supplement to a return is not taken into account if filed after the taxpayer has been contacted for audit or such other date as the IRS specifies. (IRC Sec. 6662(i)(3)) The penalty doesn't apply to any portion of an underpayment on which a fraud penalty is imposed. (Committee Report)

The reasonable cause and good faith exception doesn't apply to any portion of an underpayment which is attributable to a transaction lacking economic substance, or failing to meet the requirements of any similar rule of law. (IRC Sec. 6664(c)(2), as amended by Reconciliation Act Sec. 1409(c)) Thus, outside opinions or in-house analysis would not protect a taxpayer from imposition of a penalty if it is determined that the transaction lacks economic substance or fails to meet the requirements of any similar rule of law. (Committee Report)

The IRC Sec. 6662A accuracy-related penalty for reportable transactions won't apply to any portion of an understatement on which a IRC Sec. 6662 accuracy-related penalty is imposed if the rate of the penalty is determined under the new 40% rule in IRC Sec. 6662(i). (IRC Sec. 6662A(e)(2)(B), as amended by Reconciliation Act Sec. 1409(b)(3)(A)) The reasonable cause exception for the penalty for reportable transaction understatements in IRC Sec. 6664(d) doesn't apply to any portion of a reportable transaction understatement which is attributable to one or more transactions that lack economic substance under IRC Sec. 7701(o) or fail to meet the requirements of any similar rule of law. (IRC Sec. 6664(d)(2), as amended by Reconciliation Act Sec. 1409(c)(2))

Since many reportable transactions qualify as transactions lacking economic substance, the above rules will greatly reduce the availability of the reasonable cause exception.

For refunds and credits attributable to transactions entered into after March 30, 2010, a claim for refund or credit that is excessive under IRC Sec. 6676 due to a claim that is lacking in economic substance or failing to meet the requirements of any similar rule of law is subject to the 20% penalty under IRC Sec. 6676, and the reasonable basis exception is not available. (IRC Sec. 6676(c), Committee Report)

## Small Employers May Establish Simple Cafeteria Plans

Under a cafeteria plan, an employer may offer a menu of nontaxable benefits and cash (or certain other taxable benefits) from which participating employees may select. The value of nontaxable qualified benefits that a participant elects to receive is not includible in his income. However, under requirements that plans not discriminate in favor of highly compensated participants or key employees, plan benefits received by these individuals under a discriminatory cafeteria plan are includible in their income.

**New Law:** For years beginning after December 31, 2010, small employers may provide employees with a "simple cafeteria plan." (IRC Sec. 125(j), as amended by Health Care Act Sec. 9022(a)) Under such a plan, an eligible small employer is provided with a safe harbor from the nondiscrimination requirements for cafeteria plans as well as from the nondiscrimination requirements for specified qualified benefits offered under a cafeteria plan, including group term life insurance, benefits under a self-insured medical expense reimbursement plan, and benefits under a dependent care assistance program. (Committee Report)

An eligible employer (with 100 or fewer employees, see below) that maintains a simple cafeteria plan with respect to which the requirements described below are met for any year, is treated as meeting any applicable nondiscrimination requirement during the year. (IRC Sec. 125(j)(1)) For these purposes, a "simple cafeteria plan" is a cafeteria plan that:

1. Is established and maintained by an eligible employer,
2. Meets prescribed contribution requirements, and
3. Meets prescribed eligibility and participation requirements. (IRC Sec. 125(j)(2))

To create a simple cafeteria plan, the employer must make a contribution to provide qualified benefits under the plan on behalf of each qualified employee (without regard to whether a qualified employee makes any salary reduction contribution) in an amount equal to:

1. A uniform percentage (not less than 2%) of the employee's compensation for the plan year, or
2. An amount which is not less than the lesser of (a) 6% of the employee's compensation for the plan year, or (b) twice the amount of the salary reduction contributions of each qualified employee. (IRC Sec. 125(j)(3)(A))

For these purposes, "compensation" has the meaning given the term by IRC Sec. 414(s). (IRC Sec. 125(j)(7))

A salary reduction contribution means, with respect to a cafeteria plan, any amount which is contributed to the plan at the election of the employee and which is not includible in gross income under the simple cafeteria plan rules. (IRC Sec. 125(j)(3)(D)(i))

The requirements described in item 2, above, are not treated as met if, under the plan, the rate of contributions with respect to any salary reduction contribution of a highly compensated or key employee, at any rate of contribution, is greater than the rate for an employee who is not a highly compensated or key employee. However, an employer may otherwise make contributions to provide qualified benefits under the plan in addition to the required contributions described above. (IRC Sec. 125(j)(3)(C)) For purposes of the contribution requirements, a "qualified employee" is, with respect to a cafeteria plan, any employee who is not a "highly compensated employee" or a "key employee," and who is eligible to participate in the plan. A "highly compensated employee" means the same as it does under IRC Sec. 414(q). And a "key employee" means the same as it does under IRC Sec. 416(i). (IRC Sec. 125(j)(3)(D))

The minimum eligibility and participation requirements to be a simple cafeteria plan are met for any year if, under the plan, (a) all employees who had at least 1,000 hours of service for the preceding plan year are eligible to participate, and (b) each employee eligible to participate in the plan may, subject to terms and conditions applicable to all participants, elect any benefit available under the plan. (IRC Sec. 125(j)(4)(A)) However, an employer may elect to exclude under the plan employees who:

1. Have not attained the age of 21 before the close of a plan year,
2. Have less than one year of service with the employer as of any day during the plan year,
3. Are covered under an agreement which the Secretary of Labor finds to be a collective bargaining agreement, if there is evidence that the benefits covered under the cafeteria plan were the subject of good faith bargaining between employee representatives and the employer, or
4. Are described in IRC Sec. 410(b)(3)(C) (relating to nonresident aliens working outside the U.S.). (IRC Sec. 125(j)(4)(B))

For purposes of items 1 and 2 above, a plan may provide a shorter period of service or younger age. (IRC Sec. 125(j)(4)(B))

For purposes of the simple cafeteria plan rules, an “eligible employer” is, with respect to any year, any employer that employed an average of 100 or fewer employees on business days during either of the two preceding years. For these purposes, a year may only be taken into account if the employer was in existence throughout the year. If an employer was not in existence throughout the preceding year, the determination is based on the average number of employees that it is reasonably expected the employer will employ on business days in the current year. (IRC Sec. 125(j)(5))

If (a) an employer was an eligible employer for any year (a “qualified year”), and (b) the employer established a simple cafeteria plan for its employees for that year, then, notwithstanding the fact the employer fails to meet the “eligible employer” requirements described above for any later year, the employer will be treated as an eligible employer for that later year with respect to employees (whether or not employees during a qualified year) of any trade or business which was covered by the plan during any qualified year. However, this rule won’t apply if the employer employs an average of 200 or more employees on business days during any year preceding any such later year. (IRC Sec. 125(j)(5)(C))

## Medicine for Employer Health Plan Payouts Limited to Prescribed Drugs and Insulin

Expenses for medical care, not compensated for by insurance or otherwise, may be claimed as an itemized deduction to the extent they exceed, under pre-Act law, 7.5% of adjusted gross income (AGI). Medical care generally is defined broadly as amounts paid for diagnoses, cure, mitigation, treatment or prevention of disease, or for the purpose of affecting any structure of the body. However, any amount paid during a tax year for medicine or drugs is explicitly deductible as a medical expense only if it is a prescribed drug or is insulin. Thus, any amount paid for nonprescription medicine is not deductible as a medical expense, including any medicine recommended by a physician.

Reimbursements under an accident or health plan for medical care expenses for employees, their spouses, and their dependents generally are excluded from gross income. An employer may agree to reimburse expenses for medical care of its employees (and their spouses and dependents), not covered by a health insurance plan, through a flexible spending arrangement (FSA) which allows reimbursement not in excess of a specified dollar amount. The dollar amount is either elected by an employee under a cafeteria plan (health FSA) or otherwise specified by the employer under a health reimbursement account (HRA). Reimbursements under these arrangements are also excludible from gross income as employer-provided health coverage. The general definition of medical care without the explicit limitation on medicine applies for the exclusion for employer-provided health coverage and medical care. Thus, under an HRA or under a health FSA, amounts paid for prescription and over-the-counter medicine are treated as medical expenses, and reimbursements for these amounts are excludible from gross income.

Individuals with a high deductible health plan (and generally no other health plan) purchased either through the individual market or through an employer may, with certain limitations, establish and make tax-deductible contributions to a health savings account (HSA). Distributions from an HSA that are used for qualified medical expenses are excludible from gross income. The general definition of medical care without the explicit limitation on medicine also applies for purposes of the HSA. Similar rules apply for an Archer medical savings account (MSA). Thus, a distribution from a HSA or an Archer MSA used to buy over-the-counter medicine also is excludible as an amount used for qualified medical expenses.

**New Law:** The definition of medical expense for purposes of employer-provided health coverage (including HRAs and health FSAs), HSAs, and Archer MSAs, is conformed to the definition for purposes of the itemized deduction for medical expenses, except that a prescribed drug is determined without regard to whether it is available without a prescription. The changed definition for HSAs and Archer MSAs applies for amounts paid out with respect to tax years beginning after December 31, 2010. The changed definition for health FSAs and HRAs applies for reimbursement of expenses incurred with respect to tax years beginning after December 31, 2010. (IRC Sec. 106(f), IRC Sec. 220(d)(2)(A), and IRC Sec. 223(d)(2)(A), as amended by Health Care Act Sec. 9003)

Thus, under the provision, the cost of over-the-counter medicines can’t be reimbursed with excludible income through a health FSA, HRA, HSA, or Archer MSA, unless the medicine is prescribed by a doctor.

Many formerly prescription only drugs, such as anti-reflux medicines, are now available over the counter. Under the new law, these currently over the counter medicines will continue to be eligible to be reimbursed with excludible income if formally prescribed by a doctor.

## W-2 Reporting for Cost of Employer-provided Health Coverage

Every employer must furnish each employee and the IRS with a statement of compensation information on Form W-2, including wages, paid by the employer to the employee, and the taxes withheld from such wages during the calendar year. Under pre-Act law, there is no requirement that the employer report the total value of employer-sponsored health insurance coverage on the Form W-2, although some employers voluntarily report the amount of salary reduction under a cafeteria plan resulting in tax-free employee benefits in box 14.

**New Law:** For tax years beginning after December 31, 2010, an employer must disclose on each employee’s annual Form W-2 the value of the employee’s health insurance coverage sponsored by the employer. (IRC Sec. 6051(a)(14), as amended by Health Care Act Sec. 9002) If an employee enrolls in employer-sponsored health insurance coverage under multiple plans, the employer must disclose the aggregate value of all such health coverage (excluding the value of a health flexible spending arrangement (FSA)). (Committee Report)

For example, if an employee enrolls in employer-sponsored health insurance coverage under a major medical plan, a dental plan, and a vision plan, the employer must report the total value of the combination of all of these health-related insurance policies. For this purpose, employers generally use the same value for all similarly situated employees receiving the same category of coverage (such as single or family health insurance coverage). (Committee Report)

The value of employer-sponsored health insurance coverage is found by calculating the applicable premiums for the tax year for the employee under the rules for COBRA continuation coverage under IRC Sec. 4980B(f)(4) (and accompanying regulations), including the special rule for self-insured plans. The value reported on Form W-2 is the portion of the aggregate premium. (Committee Report)

If the plan provides for the same COBRA continuation coverage premium for both individual coverage and family coverage, the plan must calculate separate individual and family premiums for this purpose. (Committee Report)

The reporting requirement for the cost of employer-sponsored coverage doesn't apply to coverage for amounts contributed by an employer to: (1) any Archer medical savings account of an employee or the employee's spouse; or (2) to a health savings account of an employee or the employee's spouse. (IRC Sec. 6051(a)(14)(A))

Under pre-Health Care Act law, employer contributions to Archer medical savings accounts and health savings accounts were already required to be reported on Form W-2.

In addition, reporting isn't required for the amount of any salary reduction contributions to a flexible spending arrangement (within the meaning of IRC Sec. 125). (IRC Sec. 6051(a)(14)(B))

## Information Reporting Required for Payments to Corporations

In general, all persons engaged in a trade or business must file with the IRS an information return for payments made to another person in the course of the payor's trade or business that constitute fixed or determinable income aggregating $600 or more in any tax year. Payments are those for: salaries, wages, commissions, fees, and other forms of compensation for services rendered amounting to $600 or more in a tax year; and interest, rents, royalties, annuities, pensions, and other gains, profits, and income amounting to $600 or more in a tax year. The payor also must provide the payment recipient with an annual statement showing the aggregate payments made and contact information for the payor.

Payments made to corporations and certain other types of entities are generally excepted from these information reporting requirements by Reg. § 1.6041-3(p)(1). Nevertheless, the following types of payments to corporations must be reported:

1. Medical and health care payments of at least $600;
2. Fish purchases totaling at least $600 cash;
3. Attorney's fees (of any amount);
4. Gross proceeds paid to an attorney of $600 or more;
5. Substitute payments in lieu of dividends or tax-exempt interest (of any amount); and
6. Payments by a federal executive agency for services (for contracts exceeding $25,000).

**New Law:** For payments made after December 31, 2011, notwithstanding any IRS regulation issued before March 23, 2010, for information reporting purposes, “person” includes any corporation that is not exempt from tax under IRC Sec. 501(a). (IRC Sec. 6041(h), as amended by Health Care Act Sec. 9006(a)) Thus, a business must file an information return for all payments aggregating $600 or more in a calendar year to a single payee (other than a payee that is a tax-exempt corporation), notwithstanding any regulation promulgated before March 23, 2010.

The IRS will have to amend Reg. § 1.6041-3(p)(1) so that it no longer exempts from information reporting, payments aggregating $600 or more in one calendar year to corporations (other than tax-exempt corporations).

This information-reporting provision will increase the paperwork burden on businesses that routinely make payments each year totaling $600 or more per corporation.

## Hospital Insurance Tax Increased for High Wage Workers

The Federal Insurance Contributions Act (FICA) imposes two taxes on employees on wages received with respect to employment. Similar taxes are imposed on wages paid by employers.

The Old Age, Survivors and Disability Insurance (OASDI) tax is imposed at a 6.2% rate, on wages up to an annually-adjusted “wage base” ($106,800 for 2010). The Medicare Hospital Insurance (HI) tax is imposed at a 1.45% rate on all wages, regardless of amount.

The Self-Employment Contributions Act (SECA) imposes two taxes on self-employed individuals, the OASDI tax and the HI tax. There is also an annually-adjusted “ceiling” limitation on the OASDI tax ($106,800 for 2010), but no limit on the HI tax. The OASDI rate is 12.4%. The HI rate is 2.9%.

An above-the-line income tax deduction is allowed for half of the SECA taxes. In computing net earnings from self-employment, in lieu of the deduction of half of the SECA taxes, a taxpayer is allowed a deduction under IRC Sec. 1402(a)(12) equal to the taxpayer’s net earnings from self-employment, as determined before taking the IRC Sec. 1402(a)(12) deduction into account, multiplied by half of the sum of the OASDI tax rate and the HI tax rate.

**New Law:** For tax years beginning after 2012, an additional 0.9% HI tax will be imposed on taxpayers (other than corporations, estates, or trusts) on wages received with respect to employment in excess of:

- $250,000 for joint returns,
- $125,000 for married taxpayers filing a separate return, and
- $200,000 in all other cases. (IRC Sec. 3101(b)(2), as amended by Health Care Act Sec. 9015(a)(1)(D), as amended by Health Care Act Sec. 10906(a))

These threshold amounts, and the ones below for the additional SECA tax, aren’t indexed for inflation. Thus, the HI tax rate will be 1.45% on the first $200,000 of wages ($250,000 of combined wages on a joint return); and 2.35% (1.45% + 0.9%) on wages in excess of $200,000 ($250,000 of combined wages on a joint return).

This change doesn’t affect the HI tax imposed on employers.

The employer must withhold the additional 0.9% HI tax on wages that the employee receives from the employer. The employer may disregard the amount of wages received by the employee's spouse. (IRC Sec. 3102(f)(1), as amended by Health Care Act Sec. 9015(a)(2))

The employer will not be liable for any additional 0.9% HI tax that it fails to withhold and that the employee later pays, but will be liable for any penalties resulting from its failure to withhold. (IRC Sec. 3102(f)(3)) The employee will be liable for the additional 0.9% HI tax to the extent it isn't deducted by the employer. (IRC Sec. 3102(f)(2))

The additional 0.9% HI tax, to the extent not withheld, is treated as SECA tax for purposes of determining the taxpayer's estimated tax liability. (IRC Sec. 6654(m), as amended by Reconciliation Act Sec. 1402(b)(2))

For tax years beginning after December 31, 2012, an additional 0.9% HI tax will be imposed on taxpayers (other than corporations, estates, or trusts) on self-employment income for the tax year in excess of:

- $250,000 for joint returns,
- $125,000 for married taxpayers filing a separate return, and
- $200,000 in all other cases. (IRC Sec. 1401(b)(2), as amended by Health Care Act Sec. 9015(b)(1)(B), as amended by Health Care Act Sec. 10906(b))

Thus, the tax rate for the HI portion of the SECA taxes will be 2.9% on the first $200,000 of self-employment income ($250,000 of combined self-employment income on a joint return); and 3.8% (2.9% + 0.9%) on self-employment income in excess of $200,000 ($250,000 of combined self-employment income on a joint return).

The above thresholds will be reduced (but not below zero) by the amount of wages taken into account in determining the additional 0.9% HI tax on employees under IRC Sec. 3101(b)(2) (above). (IRC Sec. 1401(b)(2)(B), as amended by Reconciliation Act Sec. 1402(b)(1)(B)(ii))

The income tax deduction for half of SECA taxes will be computed without regard to the additional 0.9% SECA tax. (IRC Sec. 164(f), as amended by Health Care Act Sec. 9015(b)(2)(A))

**Observation:** Thus, although taxpayers will pay the HI portion of SECA tax at a 3.8% rate on the excess over the $200,000 or $250,000 threshold, the income tax deduction for half of SECA taxes will be computed based on a 2.9% rate. The additional 0.9% tax won't generate an income tax deduction.

The IRC Sec. 1402(a)(12) deduction from net earnings from self-employment will be computed using half the sum of the OASDI tax rate and the regular HI tax rate (i.e., 7.65%), without regard to the additional 0.9% SECA tax. (IRC Sec. 1402(a)(12)(B), as amended by Health Care Act Sec. 9015(b)(2)(B))

## Medical Expense Deduction Threshold Increased

Under pre-Act law an individual who itemized could deduct certain unreimbursed medical expenses paid during the year for himself, his spouse, and his dependents, to the extent that those expenses exceeded 7.5% (the 7.5% floor) of the individual's adjusted gross income (AGI) for the tax year. For alternative minimum tax (AMT) purposes, medical expenses are *deductible to the extent they exceed 10% (rather than 7.5%) of the taxpayer's AGI.*

**New Law:** For tax years beginning after December 31, 2012, the floor beneath the itemized deduction for medical expenses is increased from 7.5% of AGI to 10% of AGI. Thus, an individual's unreimbursed medical expenses will be deductible to the extent they exceed 10% of the individual's AGI for the tax year. (IRC Sec. 213(a), as amended by Health Care Act Sec. 9013(a))

**Illustration:** For 2013, Individual A, age 42, has $25,000 of medical expenses and AGI of $100,000. A may deduct, as a medical expense, the excess of $25,000 over $10,000 ($100,000 × 10%), or $15,000. The other $10,000 of Y's medical expenses will be permanently lost.

For tax years beginning after December 31, 2012 and ending before January 1, 2017—i.e., for 2013, 2014, 2015, and 2016—the 7.5% floor will apply if the taxpayer or his or her spouse has reached age 65 before the close of the tax year. (IRC Sec. 213(f)) Thus, the 10% floor will take effect for such "seniors" for tax years ending after December 31, 2016.

The 7.5% floor will apply to a married taxpayer for 2013 through 2016 if either the taxpayer or the taxpayer's spouse is 65, whether they file a joint return or separate returns.

For AMT purposes, the 10% floor continues to apply, and there is no special rule for seniors. (IRC Sec. 56(b)(1)(B), as amended by Health Care Act Sec. 9013(c))

From 2013 through 2016, because they are subject to a 7.5% floor for regular tax purposes, but a 10% floor for AMT purposes, seniors must make an AMT adjustment equal to the lesser of: (1) 2.5% of AGI or (2) the entire regular-tax medical deduction.

For 2013, Individual Z, age 68, has AGI of $100,000 and incurred $11,000 of medical expenses. For regular-tax purposes, Z's medical deduction is $3,500—$11,000 minus $7,500 (7.5% of AGI). However, for AMT purposes, Z's medical deduction is only $1,000—$11,000 minus $10,000 (10% of AGI). Thus, $2,500, the amount by which the medical deduction is reduced for AMT purposes, is added back to taxable income in determining alternative minimum taxable income (AMTI).

## Deduction for Subsidized Retiree Drug Costs Eliminated

Sponsors of qualified retiree prescription drug plans are eligible for subsidy payments from the Secretary of Health and Human Services for a portion of each qualified covered retiree's gross covered prescription drug costs ("qualified retiree prescription drug plan subsidy"). These qualified retiree prescription drug plan subsidies are excludable from the taxpayer's (plan sponsor's) gross income for regular income tax and alternative minimum tax (AMT) purposes.

The Code generally doesn't permit a deduction for any expense that would otherwise be allowable as a deduction if the expense is allocable to a class of exempt income. However, the exclusion of the qualified retiree prescription drug plan subsidy from income isn't taken into account in determining whether any deduction is allowable with respect to covered retiree prescription drug expenses that are taken into account in determining the subsidy payment.

Thus, a taxpayer may claim a business deduction for covered retiree prescription drug expenses incurred, notwithstanding that it excluded qualified retiree prescription drug plan subsidies allocable to those expenses.

**New Law:** For tax years beginning after December 31, 2012, the amount otherwise allowable as a deduction for retiree prescription drug expenses will be reduced by the amount of the excludable subsidy payments received. (IRC Sec. 139A, as amended by Health Care Act Sec. 9012, as amended by Reconciliation Act Sec. 1407)

**Illustration:** A company receives a $28 subsidy for $100 of eligible drug expenses. The $28 is excludable from income under IRC Sec. 139A, and the amount otherwise allowable as a deduction will be reduced by the $28. If the company otherwise meets the IRC Sec. 162 requirements for its eligible drug expenses, it is entitled to a $72 ordinary business expense deduction.

## Medicare Contribution Tax on Unearned Income

For tax years beginning after December 31, 2012, an unearned income Medicare contribution tax is imposed on individuals, estates, and trusts. (IRC Sec. 1411, as added by the Reconciliation Act Sec. 1402(a)) For an individual, the tax is 3.8% of the lesser of either (1) net investment income or (2) the excess of modified adjusted gross income (MAGI) over the threshold amount. (IRC Sec. 1411(a)(1)) MAGI is adjusted gross income (AGI) increased by the amount excluded from income as foreign earned income under IRC Sec. 911(a)(1) (net of the deductions and exclusions disallowed for the foreign earned income). (IRC Sec. 1411(d)) The threshold amount is $250,000 for a joint return or surviving spouse, $125,000 for a married individual filing a separate return, and $200,000 for all others. (IRC Sec. 1411(b)) For this purpose, gross income doesn't include excluded items, such as interest on tax-exempt bonds, veterans' benefits, and excluded gain from the sale of a principal residence. (Committee Report)

The tax is generally levied on income from interest, dividends, annuities, royalties, rents, and capital gains. The Medicare contribution tax is in addition to the 0.9% HI tax on employee's wages and on self-employment income in excess of threshold amounts, as discussed above. Taxpayers who have both high wages or self-employment income and high investment income may be hit with both taxes.

**Illustration:** For 2013, a single taxpayer has net investment income of $100,000 and MAGI of $220,000. The taxpayer would pay a Medicare contribution tax only on the $20,000 amount by which his MAGI exceeds his threshold amount of $200,000, because that is less than his net investment income of $100,000. Thus, the taxpayer's Medicare contribution tax would be $760 ($20,000 × 3.8%).

**Illustration:** Assume that the taxpayer in the example above had MAGI of $300,000. Because the taxpayer's MAGI exceeds his threshold amount by $100,000, he would pay a Medicare contribution tax on his full $100,000 of net investment income. Thus, the taxpayer's Medicare contribution tax would be $3,800 ($100,000 × 3.8%).

**Illustration:** Assume that for 2013 a single taxpayer has net investment income of $100,000, wages of $300,000, and MAGI of $375,000. In addition to paying a Medicare contribution tax of $3,800, as explained in Illustration (2), the taxpayer would also pay an additional HI (Medicare) tax of $900 ($100,000 0.9%) on his wages in excess of $200,000.

For an estate or trust, the Medicare contribution tax is 3.8% of the lesser of either: (1) undistributed net investment income or (2) the excess of AGI (as defined in IRC Sec. 67(e)) over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins. (IRC Sec. 1411(a)(2))

The Medicare contribution tax probably won't apply to simple trusts and grantor trusts. Simple trusts require all income to be distributed currently and don't provide for charitable contributions. They generally won't have any undistributed net investment income. To the extent that the grantor trust rules apply (under which the owner is taxed directly on the trust), the regular rules for taxing trusts and their beneficiaries don't apply.

The tax doesn't apply to a nonresident alien, a trust all the unexpired interests in which are devoted to charitable purposes, a trust that's tax-exempt under IRC Sec. 501 or a charitable remainder trust tax-exempt under IRC Sec. 664. (IRC Sec. 1411(e))

Net investment income is investment income reduced by the deductions properly allocable to such income. Investment income is the sum of:

- Gross income from interest, dividends, annuities, royalties, and rents (other than income derived from any trade or business to which the tax does not apply),
- Other gross income derived from any trade or business to which the tax applies, and
- Net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the tax does not apply. (IRC Sec. 1411(c)(1))

In the case of a trade or business, the tax applies if the trade or business is either a passive activity with respect to the taxpayer or the trade or business consists of trading financial instruments or commodities (as defined in IRC Sec. 475(e)(2)). (IRC Sec. 1411(c)(2)) The tax does not apply to other trades or businesses conducted by a sole proprietor, partnership, or S corporation. (Committee Report)

Thus, for a taxpayer that doesn't engage in a passive activity or a financial instrument or commodities trading business, "net investment income" will include nonbusiness income from interest, dividends, annuities, royalties, rents, and capital gains, minus the allocable deductions. Business income won't be included. For a taxpayer that does engage in a passive activity or a financial instrument or commodities trading business, "net investment income" will include the above items, plus the gross income (minus allocable deductions) from the passive activity or trading business

In the case of the disposition of a partnership interest or stock in an S corporation, gain or loss is taken into account only to the extent gain or loss would be taken into account by the partner or shareholder if the entity had sold all its properties for fair market value immediately before the disposition. Thus, only net gain or loss attributable to property held by the entity which is not property attributable to an active trade or business is taken into account. (IRC Sec. 1411(c)(4))

Income, gain, or loss on working capital is not treated as derived from a trade or business. (IRC Sec. 1411(c)(3))

Investment income does not include distributions from a qualified retirement plan (i.e., a plan or arrangement described in IRC Sec. 401(a), IRC Sec. 403(a), IRC Sec. 403(b), IRC Sec. 408, IRC Sec. 408A, IRC Sec. 457(b)) or amounts subject to SECA tax. (IRC Sec. 1411(c)(5))

The tax is subject to the individual estimated tax provisions. (IRC Sec. 6654, as amended by Reconciliation Act Sec. 1402(a)(2)) The tax isn't deductible in computing any tax imposed by subtitle A of the Code (relating to income taxes). (Committee Report)

## Free Choice Vouchers Must be Provided by Certain Employers

Effective for periods after December 31, 2013, employers offering minimum essential coverage through an eligible employer-sponsored plan and paying a portion of that coverage must provide qualified employees with a "free choice" voucher whose value can be applied to purchase of a health plan through the Insurance Exchange. (IRC Sec. 139D, as added by Health Care Act Sec. 10108) The employer treats the free choice voucher it pays as an amount for compensation for personal services actually rendered. (IRC Sec. 162(a))

Qualified employees are those employees:

- Who do not participate in the employer-sponsored plan;
- Whose required contribution for employer-sponsored minimum essential coverage (if they did participate in the plan) exceeds 8%, but does not exceed 9.8% of household income; and
- Whose total household income does not exceed 400% of the poverty line for the family.

After 2014, the 8% and 9.8% will be indexed to reflect the rate of premium growth over income growth between the preceding calendar year and 2013.

The amount of the free choice voucher is equal to the monthly portion of the cost of the eligible employer-sponsored plan which would have been paid by the employer if the employee were covered under the plan with respect to which the employer pays the largest portion of the cost of the plan. The amount will be equal to the amount the employer would pay for an employee with self-only coverage unless the employee elects family coverage (in which case such amount will be the amount the employer would pay for family coverage). (Health Care Act Sec. 1018(d))

If the value of the voucher exceeds the premium of the health plan chosen by the employee, the employee is paid the excess value of the voucher, and the excess amount received by the employee is includible in gross income (otherwise, the voucher doesn't result in income to the employee). (IRC Sec. 139D)

If an individual receives a voucher, he is disqualified from receiving any tax credit or cost sharing credit for the purchase of a plan in the Insurance Exchange. Similarly, if any employee receives a free choice voucher, the employer is not assessed a shared responsibility payment on behalf of that employee. (Health Care Act Sec. 1018(h) and (i))

## Health Insurance Premium Assistance Credit

Under pre-Act law there is no tax credit that is generally available to low or middle income individuals or families for the purchase of health insurance.

**New Law:** For tax years ending after December 31, 2013, there will be a new refundable tax credit (the “premium assistance credit”) to qualifying taxpayers who get health insurance coverage by enrolling in a qualified health plan (QHP) through an Exchange (see below). (IRC Sec. 36B, as added by Health Care Act Secs. 1401, 1411, and 1412, as amended by Health Care Act Secs. 10104, 10105, 10107, as further amended by Reconciliation Act Sec. 1001).

The Health Care Act requires each state to establish an “American Health Benefit Exchange” (“Exchange”) by January 1, 2014, and requires insurers to provide QHPs to be sold on these Exchanges. Thus, while the Exchanges will not be insurers themselves, they will provide access to insurers’ QHPs in a comparable way. The goal is for individuals to get affordable, quality health insurance by enrolling in a QHP through an Exchange. The new premium assistance credit applies to QHPs purchased on these Exchanges. This means that qualifying individuals will be able to use the credit to reduce their health insurance costs, if they get the coverage by enrolling in a QHP on an Exchange.

The basic rules for the premium assistance credit and cost-sharing reductions are outlined below.

Starting in 2014, “applicable taxpayers” (generally, individuals whose household income is at least 100% but not more than 400% of the federal poverty line and who don’t receive health insurance under an employer plan) will be allowed a refundable tax credit for the premiums paid during the tax year for QHP insurance coverage purchased on an Exchange. (IRC Sec. 36B(a), IRC Sec. 36B(c)(1) )

The mechanics of the credit will be as follows. An eligible individual will enroll in a plan offered through an Exchange and report his or her income to the Exchange. Based on the information provided to the Exchange, the individual will receive a premium assistance credit based on income. The IRS will pay the premium assistance credit amount directly to the insurance plan in which the individual is enrolled. The individual then will pay to the plan in which he or she is enrolled the dollar difference between the premium assistance credit amount and the total premium charged for the plan. Individuals who fail to pay all or part of the remaining premium amount will be given a mandatory three-month grace period before an involuntary termination of their participation in the plan. For employed individuals who purchase health insurance through a state Exchange, the premium payments will be made through payroll deductions. Initial eligibility for the premium assistance credit will be based on the individual’s income for the tax year ending two years before the enrollment period. (Committee Report)

The amount allowed as a premium assistance credit for a tax year will be equal to a percentage (based on the taxpayer’s household income level relative to the federal poverty line) of the amounts paid for QHP coverage of the taxpayer and qualifying family members (spouse and dependents) for the year. The calculation is computed on a sliding scale starting at 2.0% of income for taxpayers at or above 100% of the poverty line and phasing out to 9.5% of income for those at 400% of the poverty line. The reference premium will be the second lowest cost silver plan available in the individual market in the rating area in which the taxpayer resides. (IRC Sec. 36B(b))

The cost-sharing (e.g., deductibles, co-payments) that may otherwise be required under a QHP will be reduced for individuals at or below 400% of the poverty line. The standard out-of-pocket maximum limits will be reduced by two-thirds for individuals with household income of more than 100% but not more than 200% of the poverty line, by half for individuals between 201% and 300% of the poverty line, and by one-third for individuals between 301% and 400% of the poverty line. The cost-sharing subsidy is available only for those months in which an individual receives a credit under IRC Sec. 36B. (Health Care Act Sec. 1402)

Advance determinations and payments of premium assistance credits and cost-sharing reductions (sometimes referred to as "cost-sharing subsidies") are allowed. Advance payments of the credit will be made directly to the individual's insurance plan. (Health Care Act Sec. 1412)

The amount claimed as a premium assistance credit for a tax year must be adjusted to reflect premium assistance received through advance payments of the credit and any adjustments to the amount allowable as a credit. (IRC Sec. 36B(f))

The Secretary of Health and Human Services (HHS Secretary) must establish procedures for determining whether an individual who is applying for coverage in the individual market by a QHP offered through an Exchange, or who is claiming a premium assistance credit or reduced cost-sharing, meets the necessary eligibility requirements. (Health Care Act Sec. 1411)

## Information Reporting by Employers

Under pre-Act law there is no provision requiring employer reporting of health insurance coverage.

**New Law:** For periods beginning after December 31, 2013, there are new information reporting and related statement obligations for the following:

- Certain applicable large employers required to offer their full-time employees and their dependents the opportunity to enroll in minimum essential coverage under an eligible employer-sponsored plan.
- Offering employers.

Specifically, every applicable large employer required to meet the requirements of new IRC Sec. 4980H with respect to its full-time employees during a calendar year, and every offering employer, will be required, at the time the IRS prescribes, to make a return reporting certain information. (IRC Sec. 6056(a), as amended by Health Care Act Sec. 1514(a), as amended by Health Care Act Sec. 10108(j)(1))

The information required to be reported includes:

- The name, address and employer identification number of the employer.
- A certification as to whether the employer offers its full-time employees and their dependents the opportunity to enroll in minimum essential coverage under an eligible employer-sponsored plan.
- The number of full-time employees of the employer for each month during the calendar year.

- The name, address and taxpayer identification number of each full-time employee employed by the employer during the calendar year and the number of months, if any, during which the employee (and any dependents) was covered under a plan sponsored by the employer during the calendar year.
- Such other information as the IRS may require. (IRC Sec. 6056(b))

An applicable large employer is an employer who employed an average of at least 50 “full-time employees” on business days during the preceding calendar year. An offering employer is any employer who offers minimum essential coverage to its employees under an eligible employer-sponsored plan and who pays any portion of the costs of such plan, but only if the required employer contribution of any employee exceeds 8% of the wages paid by the employer to the employee. (IRC Sec. 6056(f)(1)(A))

## Penalty Tax on Large Employers Who Fail to Offer Qualifying Health Coverage

Under pre-Act law, there is no federal requirement that employers offer health insurance coverage to employees or their families.

**New Law:** For months beginning after December 31, 2013, the Act provides that under the “shared responsibility for employers regarding health coverage” excise taxes, a large employer (generally, an employer with at least 50 full-time employees) that doesn’t offer health care coverage for all its full-time employees, offers minimum essential coverage that is unaffordable (coverage with a premium required to be paid by the employee that is more than 9.5% of the employee’s household income, as defined for purposes of the premium tax credits, see discussion above), or offers minimum essential coverage that consists of a plan under which the plan’s share of the total allowed cost of benefits is less than 60%, must pay a penalty if any full-time employee is certified to the employer as having purchased health insurance through a state exchange with respect to which a tax credit or cost-sharing reduction is allowed or paid to the employee. (IRC Sec. 4980H, as added by Health Care Act Sec. 1513, as amended by Health Care Act Sec. 10106 and Health Care Act Sec. 10108, and as further amended by Reconciliation Act Sec. 1003, Committee Report)

**Observation:** Generally, if an employee is offered affordable minimum essential coverage under an employer-sponsored plan, then he is ineligible for a premium tax credit and cost sharing reductions for health insurance purchased through a state exchange. But, if he is offered minimum essential coverage that is either “unaffordable” (coverage with a premium required to be paid by the employee that is more than 9.5% of the employee’s household income, as defined for the premium tax credits) or that consists of a plan under which the plan’s share of the total allowed cost of benefits is less than 60%, then he is eligible, but only if he declines to enroll in the coverage, and purchases coverage through the exchange instead.

These excise taxes are payable on notice and demand by the IRS. The payment of any assessable payment of these excise taxes on an annual, monthly, or other periodic basis, as the IRS may prescribe (IRC Sec. 4980H(d)). These excise taxes are nondeductible under IRC Sec. 275(a)(6) (which prohibits certain taxes from being deductible) (IRC Sec. 4980H(c)(7)). Details on the excise tax follow.

For months beginning after December 31, 2013, if an "applicable large employer" (see below):

1. fails to offer to its full-time employees (and their dependents) the opportunity to enroll in "minimum essential coverage" under an "eligible employer-sponsored plan" for that month; and
2. at least *one* full-time employee has been certified to the employer as having enrolled for that month in a qualified health plan for which an "applicable premium tax credit or cost-sharing reduction"—collectively referred to as "health coverage assistance," i.e., any IRC Sec. 36B premium tax credit, cost-sharing reduction, and advance payment of the premium tax credit or cost-sharing reduction—is allowed or paid with respect to the employee;

Then, the employer must pay an assessable payment equal to: the "applicable payment amount" (see below) × the number of the employer's "full-time employees" (see below) during any month (reduced by 30 employees under the IRC Sec. 4980H(c)(2) reduction rule). (IRC Sec. 4980H(a)) The "applicable payment amount" is $166.67 for any month (that is, 1/12 of $2,000, which is adjusted for inflation after 2014). (IRC Sec. 4980H(c)(1))

**Illustration:** In 2014, an employer fails to offer minimum essential coverage and has 100 full-time employees, ten of whom receive a tax credit for the year for enrolling in a state exchange-offered plan. For each employee over the 30-employee threshold, the employer owes $2,000, for a total penalty of $140,000 ($2,000 × 70 (that is, 100 − 30)). This penalty is assessed on a monthly basis. (Committee Report)

*Excise tax on employers with employees qualifying for premium tax credits or cost-sharing assistance.*

For months beginning after December 31, 2013, if an applicable large employer:

1. offers to its full-time employees (and their dependents) the opportunity to enroll in minimum essential coverage under an eligible employer-sponsored plan for that month; and
2. at least one full-time employee of the employer has been certified to the employer as having enrolled for that month in a qualified health plan for which an applicable premium tax credit, or cost-sharing reduction, is allowed or paid with respect to the employee; then, subject to an overall limit, the employer must pay an assessable payment equal to: the number of the employer's full-time employees for any month who receive premium tax credits or cost-sharing assistance × 1/12 of $3,000 (adjusted for inflation after 2014). (IRC Sec. 4980H(b)(1)) But, the assessable payment won't be imposed for any month for any employee for whom the employer provides a free choice voucher for that month. (IRC Sec. 4980H(b)(3)) An overall limit applies under which the aggregate amount of tax for all employees of an applicable large employer for any month cannot exceed: the applicable payment amount × the number of the employer's full-time employees during that month (reduced by 30 employees under the IRC Sec. 4980H(c)(2) reduction rule). (IRC Sec. 4980H(b)(2))

**Illustration:** In 2014, an employer offers health coverage and has 100 full-time employees, 20 of whom receive a tax credit for the year for enrolling in a state exchange-offered plan. For each employee receiving a tax credit, the employer owes $3,000, for a total penalty of $60,000. The maximum penalty for this employer is capped under the overall limit at the amount of the penalty that it would have been assessed for a failure to provide coverage, or

$140,000 ($2,000 × 70 (that is, 100 − 30). Since the calculated penalty of $60,000 is less than the maximum amount, Employer pays the $60,000 calculated penalty. This penalty is assessed on a monthly basis. (Committee Report)

For a calendar year, an “applicable large employer” is one that employed an average of at least 50 “full-time employees” on business days during the preceding calendar year (for an employer that wasn’t in existence throughout the preceding calendar year, the determination is based on the average number of employees reasonably expected to be employed on business days in the current calendar year). But under an exemption, an employer will not be considered to employ more than 50 full-time employees if: (a) the employer’s workforce exceeds 50 full-time employees for 120 days, or fewer, during the calendar year; and (b) the employees in excess of 50 employed during that period of 120 days (or fewer) were seasonal workers (as defined in IRC Sec. 4980H(c)(2)(B)(ii)), e.g., retail workers employed exclusively during the holiday season. (IRC Sec. 4980H(c)(2)) Special rules apply to construction industry employers; see IRC Sec. 4980H(d)(2)(D))

Solely for purposes of determining whether an employer is an applicable large employer, in addition to including the number of full-time employees for any month otherwise determined, under a full-time equivalent rule for counting part-time workers, an employer will also have to include for that month the number of full-time employees determined by dividing (a) the aggregate number of hours of service of employees who are not full-time employees for the month, by (b) 120. (IRC Sec. 4980H(c)(2)(E))

The aggregation rules under IRC Sec. 414(b) (controlled group of corporations), IRC Sec. 414(c) (partnerships, proprietorships, etc., under common control), IRC Sec. 414(m) (affiliated service group), and IRC Sec. 414(o) (employee leasing and other arrangements treated by the IRS as a single employer) apply in determining applicable large employer status. (IRC Sec. 4980H(c)(2)(C)(i)) For persons treated as one employer under the aggregation rules, only one 30-employer reduction applies, allocated among the persons ratably on the basis of the number of full-time employees each employed. (IRC Sec. 4980H(c)(2)(D))

For any month, a “full-time employee” is an employee who is employed on average at least 30 hours of service per week. The IRS, in consultation with DOL, is to prescribe regulations, rules, and guidance as may be necessary to determine the hours of service of an employee, including rules for employees who aren’t compensated on an hourly basis. (IRC Sec. 4980H(c)(4)(B))

*Medicaid coverage.* An employer is not required to pay a penalty for any employees enrolled in Medicaid. (Committee Report)

## Penalty Tax on Individuals Who Fail to Maintain Health Insurance

Under pre-Act law, federal law does not require individuals to carry health insurance. Only Massachusetts, through its statewide program, requires individuals to have health insurance.

**New Law:** For tax years ending after December 31, 2013, nonexempt U.S. citizens and legal residents must maintain minimum essential coverage, which includes government sponsored programs (e.g., Medicare, Medicaid, Children’s Health Insurance Program), eligible employer-sponsored plans, plans in the individual market, certain grandfathered group health plans and other coverage as recognized by Health and Human Services (HHS) in coordination with the IRS (IRC Sec. 5000A, as added by Health Care Act Sec. 1501, as amended by Health Care Act Sec. 10106(a), and as further amended by Reconciliation Act Sec. 1002(a)).

The coverage requirement does not apply to:

- Individuals who cannot afford coverage because their required contribution for employer-sponsored coverage or the lowest cost “bronze plan” in the local Insurance Exchange exceeds 8% of household income for the year. After 2014, the 8% exemption is increased by the amount by which premium growth exceeds income growth. If self-only coverage is affordable to an employee, but family coverage is unaffordable, the employee is subject to the penalty if he does not maintain minimum essential coverage. However, any individual eligible for employer coverage due to a relationship with an employee (e.g., spouse or child of employee) is exempt from the penalty if that individual does not maintain minimum essential coverage because family coverage is not affordable (i.e., exceeds 8% of household income).
- Taxpayers with income below the income tax filing threshold (which for 2010 generally is $9,350 for a single person or a married person filing separately and is $18,700 for married filing jointly).
- Those exempted for religious reasons (who must be members of a recognized religious sect exempting them from self-employment taxes).
- Individuals residing outside of the U.S. (who are deemed to maintain minimum essential coverage).
- Individuals who are incarcerated or are not legally present in the U.S.
- All members of Indian tribes. (IRC Sec. 5000A(d), IRC Sec. 5000A(e), IRC Sec. 5000A(f))

Individuals may also apply to HHS for a hardship exemption due to hardship in obtaining coverage.

The monthly penalty amount for any taxpayer for any month during which any failure to maintain minimum essential coverage occurred will be an amount equal to 1/12 of the greater of a flat dollar amount or a percentage of income.

The flat dollar amount used in determining the monthly penalty amount will be an amount equal to the lesser of:

- The sum of the applicable dollar amounts (see below) for all individuals with respect to whom a failure to maintain minimum essential coverage occurred during the month, or
- 300% of the applicable dollar amount (determined without regard to the special rule for individuals under age 18, see below) for the calendar year with or within which the tax year ends.

The percentage of income used in determining the monthly penalty amount will be the following percentage of (i) the excess of the taxpayer’s household income for the tax year over (ii) the amount of gross income specified in IRC Sec. 6012(a) with respect to the taxpayer (i.e., the threshold amount of income required for income tax return filing for that taxpayer) for the tax year:

- 1.0% for tax years beginning in 2014.
- 2.0% for tax years beginning in 2015.
- 2.5% for tax years beginning after 2015. (IRC Sec. 5000A(c)(2))

Except for individuals under age 18 (see below), the “applicable dollar amount” will be:

- $95 for 2014,
- $325 for 2015, and
- $695 for 2016 and later years (subject to an adjustment for inflation after 2016, see below). (IRC Sec. 5000A(c)(3))

For calendar years after 2016, the “applicable dollar amount” will be $695, multiplied by a cost-of-living adjustment

If an applicable individual has not attained the age of 18 as of the beginning of a month, the “applicable dollar amount” for him or her for the month will be equal to half of the “applicable dollar amount” for the calendar year in which the month occurs.

Household income is the sum of the modified adjusted gross incomes (AGIs) of the taxpayer and all individuals accounted for in the family size required to file a tax return for that year. Modified AGI means AGI increased by all tax-exempt interest and foreign earned income. (IRC Sec. 5000A(c)(4))

If a taxpayer files a joint return, the individual and spouse are jointly liable for any penalty payment. The penalty applies to any period the individual does not maintain minimum essential coverage, is determined monthly, is assessed through the Code and is accounted for as an additional amount of federal tax owed. However, the penalty is not subject to the enforcement provisions of subtitle F of the Code and the use of liens and seizures otherwise authorized for collection of taxes does not apply to the collection of this penalty. Noncompliance with the personal responsibility requirement to have health coverage is not subject to criminal or civil penalties under the Code and interest does not accrue for failure to pay such assessments in a timely manner. (Committee Report)

No penalty is assessed for individuals who do not maintain health insurance for a period of three months or less during the tax year. If an individual exceeds the three month maximum during the taxable year, the penalty for the full duration of the gap during the year is applied. If there are multiple gaps in coverage during a calendar year, the exemption from penalty applies only to the first such gap in coverage. The IRS is to provide rules when a coverage gap includes months in multiple calendar years. (Committee Report)

## Qualified Health Plans May Be Offered Through Cafeteria Plans

Under pre-Act law, an employer is not required to offer health benefits. However, the employer may make health care benefits available to its employees and their dependents as a “qualified benefit” under the rules for cafeteria plans.

**New Law:** For tax years beginning after December 31, 2013, a reimbursement (or direct payment) for the premiums for coverage under any “qualified health plan” (as defined in Health Care Act Sec. 1301(a)) through a health insurance Exchange established under Health Care Act Sec. 1311 is a qualified benefit under a cafeteria plan if the employer is a qualified employer (IRC Sec. 125(f)(3)(B), as amended by Health Care Act Sec. 1515). Otherwise, reimbursement (or direct payment) for the premiums for coverage under any qualified health plan offered through an Exchange is not a qualified benefit under a cafeteria plan (IRC Sec. 125(f)(3)(A)). Thus, the Committee Report explains, a nonqualified employer cannot offer to reimburse an employee for the premium for a qualified plan that the employee purchases through the individual market in an Exchange as a health insurance coverage option under its cafeteria plan.

In broad terms, for purposes of the new Health Care Act rules, including IRC Sec. 125(f)(3), as amended by Health Care Act Sec. 1515:

- A qualified health plan is one that meets certain certification requirements, provides “an essential health benefits package,” and is offered by an insurer meeting detailed requirements. (Health Care Act Sec. 1301(a))

- A health insurance “Exchange” is a federally supervised marketplace for health insurance policies meeting specific eligibility and benefit criteria, to be made available not later than January 1, 2014, to qualifying individuals and employer groups of graduated sizes. (Health Care Act Secs. 1311 and 1312))

A qualified employer is a “small employer” that elects to make all of its full-time employees eligible for one or more qualified health plans offered in the “small group market” through an Exchange that offers qualified health plans. (Health Care Act Sec. 1312(f)(2)(A)) For this purpose, a small employer is one that employed an average of at least one but not more than 100 employees on business days during the preceding calendar year, and employs at least one employee on the first day of the plan year. (Health Care Act §1304(b)(2)(A))

However, in plan years beginning before January 1, 2016, a state may treat an employer with no more than 50 employees as a small employer (and one with 51 or more employees as a “large employer”). (2010 Health Care Act §1304(b)(3))

Beginning in 2017, each state will be able to allow issuers of health insurance coverage in the “large group market” in that state to offer qualified health plans through an Exchange. If a state allows issuers to offer qualified health plans in the large group market through an Exchange, the term “qualified employer” will include a large employer that elects to make all full-time employees of the employer eligible for one or more qualified health plans offered in the large group market through an Exchange. (Health Care Act Sec. 1312(f)(2)(B)) A “large employer” is one that employed an average of at least 101 employees on business days during the preceding calendar year, and employs at least one employee on the first day of the plan year. (Health Care Act Sec. 1304(b)(1))

A “group market” is the health insurance market under which individuals obtain health insurance coverage (directly or through any arrangement) on behalf of themselves (and their dependents) through a group health plan maintained by an employer. (Health Care Act Sec. 1304(a)(1)) “Large group markets” and “small group markets” are the health insurance markets under which individuals obtain health insurance coverage (directly or through any arrangement) on behalf of themselves (and their dependents) through a group health plan maintained by a large employer or by a small employer, respectively. (Health Care Act Sec. 1304(a)(3))

## Penalty Tax on High-Cost Employer Sponsored Health Coverage

For tax years beginning after December 31, 2017, insurers will be subject to a nondeductible excise tax if the aggregate value of employer-sponsored health insurance coverage for an employee (plus any former employee, surviving spouse and any other primary insured individual) exceeds a threshold amount. (IRC Sec. 4980I, as added by Health Care Act Sec. 9001 as amended by Health Care Act Sec. 10901, and as amended by Reconciliation Act Sec. 1401) The tax is equal to 40% of the aggregate value of the health insurance coverage that exceeds the threshold amount, calculated by way of a complex formula, explained later.

The principal components of this complex new excise tax are:

- The amount that is subject to the excise tax
- How the excise tax is computed
- Who pays the excise tax and how it is allocated

In determining the amount by which the value of employer-sponsored health insurance coverage exceeds the threshold amount, the aggregate value of all employer-sponsored health insurance coverage is taken into account, including coverage in the form of reimbursements under a health flexible spending account (FSA) or a health reimbursement account (HRA), contributions to a health savings account (HSA) or Archer medical savings account (MSA), and, except as provided below, other supplementary health insurance coverage. (IRC Sec. 4980I(d))

For purposes of the excise tax on employer-sponsored health insurance, coverage is health coverage under any group health plan offered by an employer to an employee without regard to whether the employer provides the coverage (and thus the coverage is excludable from the employee's income) or the employee pays for the coverage with after-tax dollars. Employer-sponsored health insurance coverage includes coverage under any group health plan established and maintained primarily for the civilian employees of the federal government or any of its agencies or instrumentalities and, generally, of any state government or political subdivision or any state agencies or instrumentalities.

Employer-sponsored health insurance coverage includes both fully-insured and self-insured health coverage excludable from the employee's gross income, including, in the self-insured context, onsite medical clinics that offer more than a *de minimis* amount of medical care to employees and executive physical programs. In the case of a self-employed individual, employer-sponsored health insurance coverage is coverage for any portion of which a deduction is allowable to the self-employed individual under IRC Sec. 162(l).

What's not taken into account in determining whether the value of health coverage exceeds the threshold amount:

- The value of employer-sponsored coverage for long-term care and the following benefits described in IRC Sec. 9832(c)(1) that are excepted from the portability, access and renewability requirements of the Health Insurance Portability and Accountability Act (HIPAA): (1) coverage only for accident or disability income insurance, or any combination of these coverages; (2) coverage issued as a supplement to liability insurance; (3) liability insurance, including general liability insurance and automobile liability insurance; (4) workers' compensation or similar insurance; (5) automobile medical payment insurance; (6) credit-only insurance; and (7) other similar insurance coverage, specified in regulations, under which benefits for medical care are secondary or incidental to other insurance benefits.

- The value of independent, noncoordinated coverage described in IRC Sec. 9832(c)(3) as excepted from the portability, access and renewability requirements of HIPAA if that coverage is purchased exclusively by the employee with after-tax dollars (or, in the case of a self-employed individual, for which a deduction under IRC Sec. 162(l) is not allowable). The value of employer-sponsored health insurance coverage does include the value of such coverage if any portion of the coverage is employer-provided (or, in the case of a self-employed individual, if a deduction is allowable for any portion of the payment for the coverage). Coverage described in IRC Sec. 9832(c)(3) is coverage only for a specified disease or illness or for hospital or other fixed indemnity health coverage. Fixed indemnity health coverage pays fixed dollar amounts based on the occurrence of qualifying events, including but not limited to the diagnosis of a specific disease, an accidental injury or a hospitalization, provided that the coverage is not coordinated with other health coverage.
- Any coverage under a separate policy, certificate, or contract of insurance which provides benefits substantially all of which are for treatment of the mouth (including any organ or structure within the mouth) or for treatment of the eye. (IRC Sec. 4980I(d)(1))

The amount subject to the excise tax on high cost employer-sponsored health insurance coverage for each employee is the sum of the aggregate premiums for health insurance coverage, the amount of any salary reduction contributions to a health FSA for the tax year, and the dollar amount of employer contributions to an HSA or an Archer MSA, minus the dollar amount of the threshold. The aggregate premiums for health insurance coverage include all employer-sponsored health insurance coverage including coverage for any supplementary health insurance coverage. The applicable premium for health coverage provided through an HRA is also included in this aggregate amount. (IRC Sec. 4980I(d)(2))

The tax is equal to 40% of the aggregate value of the health insurance coverage that exceeds:

1. The threshold dollar amount, which is
2. Multiplied by the health cost adjustment percentage, and finally
3. Increased by the age and gender adjusted excess premium amount. (IRC Sec. 4980I(b)(3))

In general, for 2018, the threshold dollar amount is $10,200 for individual coverage and $27,500 for family coverage. (IRC Sec. 4980I(b)(3)) However, increased thresholds apply for certain classes of taxpayers as explained below.

- An individual who has attained age of 55 who is non-Medicare eligible and receiving employer-sponsored retiree health coverage
- An individual who is covered by a plan sponsored by an employer the majority of whose employees covered by the plan are engaged in a high-risk profession
- An individual who is employed to repair or install electrical and telecommunications lines.

For these individuals, the threshold amount in 2018 is increased by:

- $1,650 for individual coverage or $3,450 for family coverage.
- The age and gender-adjusted excess premium amount (as defined below).

In 2019, the additional $1,650 and $3,450 amounts are indexed to the CPI-U, plus one percentage point, rounded to the nearest $50. In 2020 and thereafter, the additional threshold amounts are indexed to the CPI-U, rounded to the nearest $50. (IRC Sec. 4980I(b)(3)(C))

For purposes of the higher threshold, employees treated as engaged in a high risk professions are:

- Law enforcement officers
- Those engaged in fire protection activities
- Providers of out-of-hospital emergency medical care (e.g., emergency medical technicians)
- Those whose primary work is longshore work
- Those engaged in the construction, mining, agriculture (not including food processing), forestry, and fishing industries

A retiree with at least 20 years of employment in a high risk profession is also eligible for the increased threshold. (IRC Sec. 4980I(f))

Under the relaxed rule for these special classes of individuals, a person's threshold can't be increased by more than $1,650 for individual coverage or $3,450 for family coverage (indexed as described above) and the age and gender adjusted excess premium amount, even if he would qualify for an increased threshold both on account of his status as a retiree over age 55 and as a participant in a plan that covers employees in a high risk profession.

The health cost adjustment percentage is designed to increase the thresholds if growth in the cost of U.S. health care between 2010 and 2018 exceeds the projected growth for that period. The health cost adjustment percentage is equal to 100% plus the excess, if any, of (1) the percentage by which the per employee cost of coverage under the Blue Cross/Blue Shield standard benefit option under the Federal Employees Health Benefits Plan (standard FEHBP coverage) for plan year 2018 (as determined using the benefit package for standard FEHBP coverage for plan year 2010) exceeds the per employee cost of standard FEHBP coverage for plan year 2010; over (2) 55%. (IRC Sec. 4980I(b)(3)(C))

In 2019, the threshold amounts, after application of the health cost adjustment percentage in 2018, if any, are indexed to the CPI-U, as determined by the Department of Labor, plus one percentage point, rounded to the nearest $50. In 2020 and thereafter, the threshold amounts are indexed to the CPI-U as determined by the Department of Labor, rounded to the nearest $50. For each employee (other than for certain retirees and employees in high risk professions, whose thresholds are adjusted under rules described below), the age and gender adjusted excess premium amount is equal to the excess, if any, of:

- The premium cost of standard FEHBP coverage for the type of coverage provided to the individual if priced for the age and gender characteristics of all employees of the individual's employer, over

- The premium cost, determined under procedures proscribed by the IRS, for that coverage if priced for the age and gender characteristics of the national workforce. (IRC Sec. 4980I(b)(3)(C))

**Illustration:** If the growth in the cost of health care during the period between 2010 and 2018, calculated by reference to the growth in the per employee cost of standard FEHBP coverage during that period (holding benefits under the standard FEBHP plan constant during the period) is 57%, the threshold amounts for 2013 will be $10,200 for individual coverage and $27,500 for family coverage, multiplied by 102% (100% plus the excess of 57% over 55%), or $10,404 for individual coverage and $28,050 for family coverage. In 2019, the new threshold amounts of $10,404 for individual coverage and $28,050 for family coverage are indexed for CPI-U, plus one percentage point, rounded to the nearest $50.

Beginning in 2020, the threshold amounts are indexed to the CPI-U, rounded to the nearest $50.

The new threshold amounts (as indexed) are then increased for any employee by the age and gender adjusted excess premium amount, if any. For an employee with individual coverage in 2019, if standard FEHBP coverage priced for the age and gender characteristics of the workforce of the employee's employer is $11,400 and the IRS estimates that the premium cost for individual standard FEHBP coverage priced for the age and gender characteristics of the national workforce is $10,500, the threshold for that employee is increased by $900 ($11,400 less $10,500) to $11,304 ($10,404 plus $900). (Committee Report)

The excise tax is imposed pro rata on the issuers of the insurance. For a self-insured group health plan, a health FSA or an HRA, the excise tax is paid by the entity that administers benefits under the plan or arrangement (the "plan administrator"). The excise tax is paid by the employer if it acts as plan administrator to a self-insured group health plan, a health FSA or an HRA. Where an employer contributes to an HSA or an Archer MSA, the employer is responsible for payment of the excise tax, as the insurer. (IRC Sec. 4980I(c))

The excise tax is allocated pro rata among the insurers, with each insurer responsible for payment of the excise tax on an amount equal to the amount subject to the total excise tax multiplied by a fraction, having as the numerator the amount of employer-sponsored health insurance coverage provided by that insurer to the employee and having as the denominator the aggregate value of all employer-sponsored health insurance coverage provided to the employee. (IRC Sec. 4980I(c))

For a self-insured group health plan, a health FSA or an HRA, the excise tax is allocated to the plan administrator. If an employer contributes to an HSA or an Archer MSA, it is responsible for payment of the excise tax, as the insurer. The employer is responsible for calculating the amount subject to the excise tax allocable to each insurer and plan administrator and for reporting these amounts to each insurer, plan administrator and the IRS, in the form and at the time that the IRS may prescribe.

Each insurer and plan administrator is then responsible for calculating, reporting and paying the excise tax to the IRS on such forms and at such time as the IRS may prescribe.

**Illustration:** In 2018, an employee elects family coverage under a fully-insured health care policy covering major medical and dental with a value of $31,000. The health cost adjustment percentage for that year is 100%, and the age and gender adjusted excess premium amount for the employee is $600. On these facts, the amount subject to the excise tax is $2,900 ($31,000 less the threshold of $28,100 ($27,500 multiplied by 100% and increased by $600)).

The employer reports $2,900 as taxable to the insurer, which calculates and remits the excise tax to the IRS. (Committee Report)

**Illustration:** In 2018, an employee elects family coverage under a fully-insured major medical policy with a value of $28,500 and contributes $2,500 to a health FSA, and thus has an aggregate health insurance coverage value of $31,000 ($28,500 plus $2,500). The health cost adjustment percentage for that year is 100% and the age and gender adjusted excess premium amount for the employee is $600. On these facts, the amount subject to the excise tax is $2,900 ($31,000 less the threshold of $28,100 ($27,500 multiplied by 100% and increased by $600)).

The employer reports $2,666 ($2,900 × $28,500/$31,000) as taxable to the major medical insurer which then calculates and remits the excise tax to the IRS. If the employer uses a third-party administrator for the health FSA, the employer reports $234 ($2,900 × $2,500/$31,000) to the administrator and the administrator calculates and remits the excise tax to the IRS. If the employer is acting as the plan administrator of the health FSA, the employer is responsible for calculating and remitting the excise tax on the $234 to the IRS. (Committee Report)

A penalty applies to an employer that reports to insurers, plan administrators and the IRS a lower amount of insurance cost subject to the excise tax than required. The penalty is equal to the sum of any additional excise tax that each such insurer and administrator would have owed if the employer had reported correctly and interest attributable to that additional excise tax as determined under IRC Sec. 6621 from the date that the tax was otherwise due to the date paid by the employer. (IRC Sec. 4980I(e)) This may occur, for example, if the employer undervalues the aggregate premium and thereby lowers the amount subject to the excise tax for all insurers and plan administrators (including the employer, when acting as plan administrator of a self-insured plan). (Committee Report)

The penalty won't apply if it is established to the IRS's satisfaction that the employer neither knew, nor exercising reasonable diligence would have known, that the failure existed. In addition, no penalty will be imposed on any failure corrected within the 30-day period beginning on the first date that the employer knew, or exercising reasonable diligence, would have known, that the failure existed, so long as the failure is due to reasonable cause and not to willful neglect. All or part of the penalty may be waived by the IRS in the case of any failure due to reasonable cause and not to willful neglect, to the extent that the payment of the penalty would be excessive or otherwise inequitable relative to the failure involved.
(IRC Sec. 4980I(e)).

## SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers with the correct answers in the following section.

11. In 2011, Eric and June adopt twin boys. Which of the following is true with regard to the adoption credit? Assume that the twins are qualified children under these provisions.

    a. Eric and June's tax liability before the adoption credit is $5,000. The adoption credit reduces the tax liability to zero, but not below zero.

    b. Eric and June are not entitled to an adoption credit for adoptions that take place in 2011 or later.

    c. Eric and June are entitled to a credit for each of the boys.

12. Pam has two daughters, Melissa and Megan. Which daughter will qualify as a dependent for health benefits for the tax year ending December 31, 2011?

    a. Melissa is age 25 and single.

    b. Megan is age 26 and married.

13. Effective in 2010, there is a tax credit for small employers offering health coverage for their employees. Which of the following is correct about the credit?

    a. The credit is not allowed for small employers when determining AMT for federal income tax.

    b. The credit is allowed for up to 50% of nonelective contributions to purchase health insurance for its employees in 2010.

    c. The full amount of the credit is only available to small employers with 10 or fewer full-time employees whose full-time wages average less than $25,000.

    d. A qualified small business is one that has less than 50 full-time employees and average annual full-time wages of no more than $100,000.

14. On his 2011 tax return, Ted claims tax benefits resulting from a transaction entered into solely for the purpose of creating a tax benefit. Ted explains the relevant tax facts surrounding the transaction in a separate statement attached to his return. What is the amount of the tax penalty assessed on the underpayment resulting from this transaction?

    a. 0%.

    b. 20%.

    c. 40%.

15. Sellco offers a simple cafeteria plan to their employees. Sellco meets the criteria for an eligible employer under IRC Sec. 125. Which of the following employees may be excluded from the plan in accordance with IRC Sec. 125?

    a. Employees who have not completed two years of service with the company.

    b. Employees who had less than 1,500 hours of service during the preceding plan year.

    c. Employees less than 24 years of age.

    d. Nonresident aliens who received income from sources within the United States.

16. Which of the following is true regarding Sellco?

    a. Sellco commenced business operations January 1, 2011. Throughout the year, Sellco expects to employ 75 people. Sellco is *not* an eligible employer in 2011, because the company did not exist in 2010.

    b. Sellco commenced business operations January 1, 2011. Sellco expects to employ 75 people through November and plans to increase their staff to 150 people in December. Sellco is *not* an eligible employer in 2011, because they will have more than 100 employees at the end of the year.

    c. Sellco commenced business operations June 1, 2010. For the months that Sellco was in business in 2010, they employed 90 people. In 2011, they employed 150 people. Sellco is *not* a qualified employer in 2010.

    d. Sellco employed an average of 80 people in 2010, and 90 people in 2011, when they established a simple cafeteria plan. In 2012, Sellco increased its staff to 120, and in 2013 Sellco increased its staff to 205 people. Sellco will retain treatment as a small employer under the new law.

17. Under the amended Health Care Act, after December 31, 2010, which of the following would **not** be reimbursable with excludible income through a health flexible spending account?

    a. Over-the-counter medication.

    b. Prescription medication available only in a pharmacy.

18. Which of the following is a new requirement for employers to report on an employee's Form W-2, beginning in 2011?

    a. A total of wages, paid by the employer to the employee for the year.

    b. The value of the employee's health insurance coverage sponsored by the employer.

    c. The taxes the employer withheld from the employee's from wages earned during the calendar year.

    d. Employer contributions to Archer medical savings accounts.

19. For tax years beginning after 2012, an additional 0.9% HI tax will be imposed on taxpayers with wages received in excess of set amounts. What is the HI tax?
    a. Self-Employment Contributions Act.
    b. Federal Insurance Contributions Act.
    c. Old Age, Survivors and Disability Insurance.
    d. Medicare Hospital Insurance.
20. Which of the following is true about "free choice" vouchers for qualified employees that can be used to purchase a health plan through the Insurance Exchange after December 31, 2013?
    a. An employee can receive a voucher and still qualify for a tax credit for purchasing a plan in the Insurance Exchange.
    b. If the premium of the health plan chosen by the employee in the Insurance Exchange is less than the amount of the voucher, the employee receives the excess funds.
    c. An employer who offers affordable health insurance with minimum essential coverage to all employees does not have to offer the "free choice" vouchers.
    d. An employee who is qualified for the "free choice" voucher can participate in the employer-sponsored plan.
21. Listed below are several tax preparers who are learning about the premium assistance credit. Which one has the proper understanding of how the system initiating the credit works?
    a. Kay believes the premium assistance credit is a nonrefundable credit.
    b. Lonnie believes the "American Health Benefit Exchange," required to be established by each state, is an insurer.
    c. Mary believes the individual's income for the tax year ending 2012 will determine who is eligible to participate.
    d. Nester believes the credit will be paid directly to the qualifying individual who enrolls in a qualifying plan.
22. Which of the following employers would be subject to the excise tax in 2014 based on the health care choices offered to their employees?
    a. D&G Enterprises offers health care insurance to all full-time employees. The cost to all employees is $250 per month for family coverage. The average worker at D&G Enterprises makes approximately $3,000 per month.
    b. Flore and Fauna, a small business, employs 15 full-time employees. They do not currently offer health coverage to their employees.
    c. Tejas Construction does not offer health care coverage to their 75 full-time hourly workers. Most of the work force obtains health insurance through a state exchange.
    d. Brown & Briddle, a law firm, offers a health insurance plan to all of their full-time employees. The plan provides minimum essential coverage under which the plan pays 80% of the total allowed costs.

23. Which of the following is correct concerning the health coverage excise tax?

    a. When determining large employer status, any employee who works more than 30 hours per week is considered a full-time employee.

    b. Excise tax payments are made on a yearly basis to the IRS by the employer.

    c. Any penalties assessed to the employer due to the health coverage excise tax are deductible on the employer's federal tax return. [This answer is incorrect. According to IRC Sec. 275(a)(6), the excise taxes are nondeductible for the employer.]

24. Which of the following scenarios is accurate concerning an individual subject to a penalty for remaining uninsured?

    a. Barbara and Allen are married. Allen is an employee of ABC Company. Barbara does not work outside the home. Allen's employer offers health care coverage. Only Allen is insured through his employer's plan. The household income of Barbara and Allen is $30,000 for 2014. The premium for family coverage under the ABC Company plan is $2,800 annually. Barbara is uninsured and subject to a penalty.

    b. Charles is self-employed and his annual income reported on Schedule C is $150,000. Charles is unmarried and does not have an Archer Medical Savings Account or any type of health care plan. Charles is subject to the uninsured penalty.

    c. Diane is on special assignment for her employer and is residing outside the United States. Diane has no health care plan and is subject to the uninsured penalty.

    d. Elan is residing in a minimum security federal penitentiary serving a 15-year sentence for securities fraud. Elan has no health care plan and is subject to the uninsured penalty.

25. Listed below are some provisions defined in the portion of the Health Care Act covering cafeteria plans. Which one is correct?

    a. An employer may be qualified or nonqualified and still be eligible to reimburse employees for premium payments made for health care coverage through a cafeteria plan.

    b. A small employer is one who had no more than 100 employees on any day during the preceding calendar year and employed at least one employee on the first day of the plan year.

    c. In plan years beginning after January 1, 2016, an employer with 51 or more employees is a large employer.

    d. Beginning January 1, 2017, each state will offer a federally supervised health insurance exchange in the large group market.

26. Beginning in 2018, insurers will be subject to a nondeductible excise tax on the aggregate value of employer-sponsored health insurance coverage for an employee. Which of the following is true regarding this new legislation?

    a. Employees who are self-insured under an employer-sponsored health program are not subject to the excise tax.

    b. Self-employed individuals will not be subject to the excise tax, since an employer is not providing coverage.

    c. The excise tax is only applicable to the aggregate value of the health insurance coverage that exceeds a threshold amount.

    d. The coverage that is subject to the excise tax is coverage provided by the employer with no cost to the employee.

27. Which of the following people would be held to the basic threshold amount for individual coverage for employer-sponsored health insurance in 2018?

    a. Sarah works for a publishing company in the accounting department. Her company provides employer-sponsored health coverage that exceeds the threshold amount.

    b. Henry is a highway patrolman with the State of Texas. The state provides employer-sponsored health coverage to Henry.

    c. Megan works for a longshore company doing the payroll. She is the only employee of the company who does not work out in the field. The company provides employer-sponsored health coverage and Megan has family coverage.

    d. Mark, age 58, receives employer-sponsored retiree health coverage from his previous employer. Mark does not receive Medicare.

28. Who is responsible for paying the excise tax on employer-sponsored health care coverage when the group health plan is self-insured?

    a. The employer.

    b. The plan administrator.

29. In 2018, Barbara elects family coverage under a fully-insured major medical policy with a value of $29,500. In addition, Barbara contributes $3,500 to a health FSA. The health cost adjustment percentage for 2018 is 100%, and the age- and gender-adjusted excess premium amount for the employer is $700. What amount is subject to excise tax for Barbara for 2018?

    a. $0.

    b. $1,300.

    c. $4,800.

    d. $5,500.

## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

11. In 2011, Eric and June adopt twin boys. Which of the following is true with regard to the adoption credit? Assume that the twins are qualified children under these provisions. **(Page 31)**

    a. Eric and June's tax liability before the adoption credit is $5,000. The adoption credit reduces the tax liability to zero, but not below zero. [This answer is incorrect. A provision of the 2010 Act redesignates the credit as an recoverable credit, and therefore any excess of the adoption credit over the income tax is taken into account as a negative amount of tax in computing a taxpayer's tax deficiency. (IRC Sec. 6211(b)(4)(A)]

    b. Eric and June are not entitled to an adoption credit for adoptions that take place in 2011 or later. [This answer is incorrect. Under prior law, the adoption credit did not apply in 2011; however, the 2010 Act extended this credit. Therefore, Eric and June are entitled to the credit in 2011.]

    **c. Eric and June are entitled to a credit for each of the boys. [This answer is correct. The adoption credit is applied on a per-child basis. An individual can claim a tax credit for qualified adoption expenses which are reasonable and necessary, and is applied per eligible child.]**

12. Pam has two daughters, Melissa and Megan. Which daughter will qualify as a dependent for health benefits for the tax year ending December 31, 2011? **(Page 32)**

    **a. Melissa is age 25 and single. [This answer is correct. The Reconciliation Act provides that the general exclusion for employer-provided coverage and reimbursements under accident and health plans applies to participant's children who have not attained age 27 as of the end of the tax year.]**

    b. Megan is age 26 and married. [This answer is incorrect. Under the Health Care Act, if coverage is provided for dependent children, the coverage must continue until the dependents turn 26, as long as they aren't married.]

13. Effective in 2010, there is a tax credit for small employers offering health coverage for their employees. Which of the following is correct about the credit? **(Page 33)**

    a. The credit is not allowed for small employers when determining AMT for federal income tax. [This answer is incorrect. According to the IRS Code detailing the small employer insurance credit, the credit is allowed for the AMT.]

    b. The credit is allowed for up to 50% of nonelective contributions to purchase health insurance for its employees in 2010. [This answer is incorrect. According to the small employer health insurance credit, the maximum amount of the credit is 35% for 2010 to 2013, changing to 50% up to two years for those who purchase through an insurance exchange for 2014 and beyond.]

    **c. The full amount of the credit is only available to small employers with 10 or fewer full-time employees whose full-time wages average less than $25,000. [This answer is correct. While the credit is available to larger qualified small businesses, the full amount of the credit is only available to an employer with 10 or fewer full-time employee, whose average annual full-time equivalent wages are less than $25,000 per the small employer health insurance credit.]**

d. A qualified small business is one that has less than 50 full-time employees and average annual full-time wages of no more than $100,000. [This answer is incorrect. A qualified small business can have no more than 25 full-time equivalent employees and annual full-time equivalent wages averaging no more than $50,000 to qualify for the health coverage tax credit.]

14. On his 2011 tax return, Ted claims tax benefits resulting from a transaction entered into solely for the purpose of creating a tax benefit. Ted explains the relevant tax facts surrounding the transaction in a separate statement attached to his return. What is the amount of the tax penalty assessed on the underpayment resulting from this transaction? **(Page 37)**

    a. 0%. [This answer is incorrect. Transactions that don't meet the new uniform definition of the economic substance doctrine are subject to a liability penalty under IRC Sec. 6662.]

    **b. 20%. [This answer is correct. The penalty rate under IRC Sec. 6662 is 20% for underpayments that are attributable to transactions entered into after March 30, 2010, when the taxpayer adequately discloses the relevant facts affecting the tax treatment in the return.]**

    c. 40%. [This answer is incorrect. The standard penalty rate under IRC Sec. 6662 for underpayments that are attributable to transactions entered into after March 30, 2010, for a taxpayer that adequately discloses the relevant facts affecting the tax treatment in the return is 20%. However, the penalty rate increases to 40% if the taxpayer does not adequately disclose the relevant facts affecting the tax treatment in the return or a statement attached to the return.]

15. Sellco offers a simple cafeteria plan to their employees. Sellco meets the criteria for an eligible employer under IRC Sec. 125. Which of the following employees may be excluded from the plan in accordance with IRC Sec. 125? **(Page 39)**

    a. Employees who have not completed two years of service with the company. [This answer is incorrect. Per IRC Sec. 125(j)(4)(B)(ii), employers may exclude from the plan employees who have less than one year of service with the company.]

    b. Employees who had less than 1,500 hours of service during the preceding plan year. [This answer is incorrect. All employees who had at least 1,000 hours of service in the preceding plan year must be eligible to participate unless a specific statutory exclusion is met according to IRC Sec. 125. (j)(4)(B)(ii).]

    c. Employees less than 24 years of age. [This answer is incorrect. Under IRC Sec. 125 (j)(4)(B)(ii), employees who are less than 21 years of age may be excluded from the plan.]

    **d. Nonresident aliens who received income from sources within the United States. [This answer is correct. Employees who are described in IRC Sec. 410(b)(3)(C) (referring to nonresident aliens outside the United States) may be excluded from the plan.]**

16. Which of the following is true regarding Sellco? **(Page 39)**

    a. Sellco commenced business operations January 1, 2011. Throughout the year, Sellco expects to employ 75 people. Sellco is **not** an eligible employer in 2011, because the company did not exist in 2010. [This answer is incorrect. For the purposes of a company that did not exist in the preceding year, the determination of eligibility is based on the number of people the company is reasonably expected to employ in the current year.]

    b. Sellco commenced business operations January 1, 2011. Sellco expects to employ 75 people through November and plans to increase their staff to 150 people in December. Sellco is **not** an eligible employer in 2011, because they will have more than 100 employees at the end of the year. [This answer is incorrect. For the purposes of a company that did not exist in the preceding year, the determination of eligibility is based on the average number of people the company is reasonably expected to employ in the current year. The average number of employees expected to be employed in 2011 is 81 for the year, and therefore Sellco is an eligible employer.]

    **c. Sellco commenced business operations June 1, 2010. For the months that Sellco was in business in 2010, they employed 90 people. In 2011, they employed 150 people. Sellco is *not* a qualified employer in 2010. [This answer is correct. An eligible employer is one that employed an average of 100 or fewer employees on business days during either of the two preceding years. However, if the employer was not in business throughout the prior year, the determination of eligibility is based on the number of people the company is reasonably expected to employ in the current year. In this case, Sellco was not in business throughout 2010, and in 2011, they exceeded 100 employees.]**

    d. **Sellco** employed an average of 80 people in 2010, and 90 people in 2011, when they established a simple cafeteria plan. In 2012, Sellco increased its staff to 120, and in 2013 Sellco increased its staff to 205 people. Sellco will retain treatment as a small employer under the new law. [This answer is incorrect. Although growing employers may retain treatment as a small employer under IRC Sec. 125, if an employer was an eligible employer for any year and sets up a simplified plan, this exclusion will cease to apply if the employer increases the average number of employees to over 200.]

17. Under the amended Health Care Act, after December 31, 2010, which of the following would **not** be reimbursable with excludible income through a health flexible spending account? **(Page 40)**

    **a. Over-the-counter medication. [This answer is correct. Under the new provision, the cost of over-the-counter medicines can't be reimbursed with excludible income through a health FSA, HRA, HSA, or Archer MSA unless prescribed by a doctor. Over-the-counter medication does not conform to the definition of a medical expense for the purpose of the itemized deduction for medical expenses.]**

    b. Prescription medication available only in a pharmacy. [This answer is incorrect. The definition of medical expenses for purposes of employer-provided health coverage (including HRAs and health FSAs), HSAs, and Archer MSAs, is conformed to the definition for purposes of the itemized deduction for medical expenses, which states that medical care is generally defined as amount paid for diagnoses, cure, mitigation, treatment or prevention of disease, or for the purpose of affecting any structure of the body. Any amount paid during a tax year for medicine or drugs is explicitly deductible as a medical expense only if it is a prescribed drug or insulin.]

18. Which of the following is a new requirement for employers to report on an employee's Form W-2, beginning in 2011? **(Page 40)**

    a. A total of wages, paid by the employer to the employee for the year. [This answer is incorrect. According to IRS Code, every employer must furnish each employee and the IRS with a statement of compensation information on Form W-2. It must include wages that are paid by the employer to the employee. This is not a new requirement for 2011.]

    **b. The value of the employee's health insurance coverage sponsored by the employer. [This answer is correct. For tax years beginning after December 31, 2010, an employer must disclose on each employee's annual Form W-2 the value of the employee's health insurance coverage sponsored by the employer. (IRC Sec. 6051(a)(14), as amended by Health Care Act Sec. 9002)]**

    c. The taxes the employer withheld from the employee's from wages earned during the calendar year. [This answer is incorrect. According to IRS Code, every employer must furnish each employee and the IRS with a statement of compensation information on Form W-2. One item that must be included on the W-2 form is taxes the employer withheld from the employee's from wages earned during the calendar year. This is not a new requirement for 2011.]

    d. Employer contributions to Archer medical savings accounts. [This answer is incorrect. Under pre-Health Care Act law, employer contributions to Archer medical savings accounts and health savings accounts were already required to be reported on Form W-2. This is not a new requirement for 2011.]

19. For tax years beginning after 2012, an additional 0.9% HI tax will be imposed on taxpayers with wages received in excess of set amounts. What is the HI tax? **(Page 42)**

    a. Self-Employment Contributions Act. [This answer is incorrect. The Self-Employment Contributions Act (SECA) imposes two taxes on self-employed individuals, the OASDI tax and the HI tax.]

    b. Federal Insurance Contributions Act. [This answer is incorrect The Federal Insurance Contributions Act (FICA) imposes two taxes on employees wages received with respect to employment. It is used to fund FICA today to provide for the federal system of old age, survivors, disability and hospital insurance.]

    c. Old Age, Survivors and Disability Insurance. [This answer is incorrect. The Old Age, Survivors and Disability Insurance (OASDI) tax is imposed at the rate of 6.2%. The OASDI is used to refer only to the benefits for retirement, disability, survivorship, and death, which are the four main benefits provided by traditional private-sector pension plans.]

    **d. Medicare Hospital Insurance. [This answer is correct. The Medicare Hospital Insurance (HI) tax is imposed currently at the rate of 1.45% on all wages, regardless of amount. It is used to fund the Medicare program. For tax years beginning after December 31, 2012, an additional 0.9% HI tax will be imposed on taxpayers (other than corporations, estates, or trusts) on self-employment income for the tax year in excess of: $250,000 for joint returns, $125,000 for married taxpayers filing separate returns and $200,000 in all other cases as stated in IRC Sec. 140(b)(2), as amended by Health Care Act Sec. 9015(b)(1)(B), as amended by Health Care Act Sec. 10906(b).]**

20. Which of the following is true about "free choice" vouchers for qualified employees that can be used to purchase a health plan through the Insurance Exchange after December 31, 2013? **(Page 47)**

    a. An employee can receive a voucher and still qualify for a tax credit for purchasing a plan in the Insurance Exchange. [This answer is incorrect. According to the Health Care Act Sec. 1018(h) and (i), if an individual receives a voucher, he is disqualified from receiving any tax credit or cost sharing credit for the purchase of a plan in the Insurance Exchange.]

    **b. If the premium of the health plan chosen by the employee in the Insurance Exchange is less than the amount of the voucher, the employee receives the excess funds. [This answer is correct. If the value of the voucher exceeds the premium of the health plan chosen by the employee, the employee is paid the excess value of the voucher, and the excess amount received by the employee is includible in gross income as stated in IRC Sec. 139D.]**

    c. An employer who offers affordable health insurance with minimum essential coverage to all employees does not have to offer the "free choice" vouchers. [This answer is incorrect. Effective for periods after December 31, 2013, employers offering minimum essential coverage though an eligible employer-sponsored plan and paying a portion of that coverage, must provide qualified employees with a "free choice" voucher whose value can be applied to the purchase of a health plan through the Insurance Exchange.]

    d. An employee who is qualified for the "free choice" voucher can participate in the employer-sponsored plan. [This answer is incorrect. Employees who are qualified for the voucher system are those employees: (1) who do not participate in the employer-sponsored plan; (2) whose required contribution for employer-sponsored minimum essential coverage exceeds 8%, but not 9.8% of household income; and (3) whose total household income does not exceed 400% of the poverty line for the family.]

21. Listed below are several tax preparers who are learning about the premium assistance credit. Which one has the proper understanding of how the system initiating the credit works? **(Page 48)**

    a. Kay believes the premium assistance credit is a nonrefundable credit. [This answer is incorrect. The premium assistance credit is refundable.]

    b. Lonnie believes the "American Health Benefit Exchange," required to be established by each state, is an insurer. [This answer is incorrect. The Exchanges are not insurers themselves; they provide access to insurers' QHPs in a comparable way.]

    **c. Mary believes the individual's income for the tax year ending 2012 will determine who is eligible to participate. [This answer is correct. Initially, eligibility for the premium assistance credit is based on the individual's income for the tax year ending two years prior to the enrollment period. The enrollment period begins in 2014.]**

    d. Nester believes the credit will be paid directly to the qualifying individual who enrolls in a qualifying plan. [This answer is incorrect. The IRS will pay the premium assistance credit directly to the insurance plan in which the individual is enrolled.]

22. Which of the following employers would be subject to the excise tax in 2014 based on the health care choices offered to their employees? **(Page 50)**

   a. D&G Enterprises offers health care insurance to all full-time employees. The cost to all employees is $250 per month for family coverage. The average worker at D&G Enterprises makes approximately $3,000 per month. [This answer is incorrect. If an employer provides health care coverage to an employee that is affordable, then the employer will not be subject to an excise tax. Unaffordable is defined as coverage with a premium required to be paid by the employee that is more than 9.5% of the employee's household income. 9.5% of $3,000 is $285—D&G Enterprises' coverage is not deemed unaffordable.]

   b. Flore and Fauna, a small business, employs 15 full-time employees. They do not currently offer health coverage to their employees. [This answer is incorrect. Flore and Fauna would not be subject to the excise tax for not offering health coverage to their employees because their business does not meet the definition of a large employer. Generally, a large employer is one with at least 50 full-time employees.]

   **c. Tejas Construction does not offer health care coverage to their 75 full-time hourly workers. Most of the work force obtains health insurance through a state exchange. [This answer is correct. According to IRC Sec. 1513, as amended by the Health Care Act, large employers that do not offer health care coverage to all of their full-time employees—if the full-time employee is certified to the employer as having purchased health insurance through a state exchange with respect to which a tax credit or cost-sharing reduction is allowed or paid to the employee—must pay a penalty, or excise tax, to the IRS.]**

   d. Brown & Briddle, a law firm, offers a health insurance plan to all of their full-time employees. The plan provides minimum essential coverage under which the plan pays 80% of the total allowed costs. [This answer is incorrect. If a company offers minimum essential health insurance in which the plan's share of the total allowed cost of benefits is less than 60%, the employer would be subject to the excise tax. Brown & Briddle offers a plan that exceeds this amount; therefore, they would not have to pay any excise tax related to their health plan.]

23. Which of the following is correct concerning the health coverage excise tax? **(Page 52)**

   **a. When determining large employer status, any employee who works more than 30 hours per week is considered a full-time employee. [This answer is correct. For any month, a "full-time employee" is an employee who is employed on average at least 30 hours of service per week per IRC Sec. 4908H(c (2)(D).]**

   b. Excise tax payments are made on a yearly basis to the IRS by the employer. [This answer is incorrect. Excise taxes are payable on notice and demand by the IRS. The IRS may provide for the payment of any assessable payment of these excise taxes on an annual, monthly or other periodic basis.]

   c. Any penalties assessed to the employer due to the health coverage excise tax are deductible on the employer's federal tax return. [This answer is incorrect. According to IRC Sec. 275(a)(6), the excise taxes are nondeductible for the employer.]

24. Which of the following scenarios is accurate concerning an individual subject to a penalty for remaining uninsured? **(Page 53)**

   a. Barbara and Allen are married. Allen is an employee of ABC Company. Barbara does not work outside the home. Allen's employer offers health care coverage. Only Allen is insured through his employer's plan. The household income of Barbara and Allen is $30,000 for 2014. The premium for family coverage under the ABC Company plan is $2,800 annually. Barbara is uninsured and subject to a penalty. [This answer is incorrect. Although Barbara has a relationship with an employee who is covered under an employer's plan, Barbara is exempt from the penalty because the premium for family coverage exceeds 8% of the household income ($30,000 × .08 = $2,400).]

   **b. Charles is self-employed and his annual income reported on Schedule C is $150,000. Charles is unmarried and does not have an Archer Medical Savings Account or any type of health care plan. Charles is subject to the uninsured penalty. [This answer is correct. Charles has income above the income tax filing threshold for a single person and would be subject to the uninsured penalty.]**

   c. Diane is on special assignment for her employer and is residing outside the United States. Diane has no health care plan and is subject to the uninsured penalty. [This answer is incorrect. Provisions in the Health Care Act specifically exclude individuals residing outside the U.S. from the uninsured penalty as they are deemed to maintain minimum essential coverage.]

   d. Elan is residing in a minimum security federal penitentiary serving a 15-year sentence for securities fraud. Elan has no health care plan and is subject to the uninsured penalty. [This answer is incorrect. Provisions in the Health Care Act specifically exclude individuals who are incarcerated from the uninsured penalty.]

25. Listed below are some provisions defined in the portion of the Health Care Act covering cafeteria plans. Which one is correct? **(Page 55)**

   a. An employer may be qualified or nonqualified and still be eligible to reimburse employees for premium payments made for health care coverage through a cafeteria plan. [This answer is incorrect. An unqualified employer cannot offer to reimburse an employee for the premium for a qualified plan that the employee purchases through the individual market in an Exchange as health insurance coverage under the employer's cafeteria plan.]

   b. A small employer is one who had no more than 100 employees on any day during the preceding calendar year and employed at least one employee on the first day of the plan year. [This answer is incorrect. An employer may have more than 100 employees on several days during the preceding calendar year. The key is that the employer average no more than 100 employees during the preceding calendar year.]

   c. In plan years beginning after January 1, 2016, an employer with 51 or more employees is a large employer. [This answer is incorrect. In plan years beginning before January 1, 2016, a large employer is one with 51 or more employees.]

   **d. Beginning January 1, 2017, each state will offer a federally supervised health insurance exchange in the large group market. [This answer is correct. The health insurance exchange is a federally supervised health insurance marketplace where qualifying individuals and employer groups of graduated sizes will be able to obtain health insurance policies.]**

26. Beginning in 2018, insurers will be subject to a nondeductible excise tax on the aggregate value of employer-sponsored health insurance coverage for an employee. Which of the following is true regarding this new legislation? **(Page 56)**

    a. Employees who are self-insured under an employer-sponsored health program are not subject to the excise tax. [This answer is incorrect. Employer-sponsored health insurance coverage includes both fully-insured and self-insured health coverage excludable from the employee's gross income, including in the self-insured context, on-site medical clinics that offer more than a *de minimis* amount of medical care to employee and executive physical programs.]

    b. Self-employed individuals will not be subject to the excise tax, since an employer is not providing coverage. [This answer is incorrect. If an individual is self-employed, employer-sponsored health insurance coverage is coverage for any portion of which a deduction is allowable to the self-employed individual under IRC Sec. 162(l).]

    **c. The excise tax is only applicable to the aggregate value of the health insurance coverage that exceeds a threshold amount. [This answer is correct. According to Code. Sec. 49801D, the excise tax is equal to 40% of the aggregate value of the health insurance coverage that exceeds the threshold amount, calculated by way of a complex formula, which is detailed in Code. Sec. 4980I(b)(3).]**

    d. The coverage that is subject to the excise tax is coverage provided by the employer with no cost to the employee. [This answer is incorrect. For purposes of the excise tax on employer-sponsored health insurance, coverage is health coverage under any group health plan offered by an employer to an employee without regard to whether the employer provides the coverage or the employee pays for the coverage with after-tax dollars.]

27. Which of the following people would be held to the basic threshold amount for individual coverage for employer-sponsored health insurance in 2018? **(Page 57)**

    **a. Sarah works for a publishing company in the accounting department. Her company provides employer-sponsored health coverage that exceeds the threshold amount. [This answer is correct. Sarah would not be subject to an increased threshold amount for 2018 because she does not fall into any of the classes of taxpayers that are held to an increased threshold amount. The 2018 threshold dollar amount is applicable for her individual coverage as detailed in IRC Sec. 4908I(b)(3).]**

    b. Henry is a highway patrolman with the State of Texas. The state provides employer-sponsored health coverage to Henry. [This answer is incorrect. Henry is treated as engaged in a high-risk profession, according to the Health Care Act, and his threshold amount in 2018 would be increased by $1,650 for individual coverage.]

    c. Megan works for a longshore company doing the payroll. She is the only employee of the company who does not work out in the field. The company provides employer-sponsored health coverage and Megan has family coverage. [This answer is incorrect. If an individual is covered by a plan sponsored by an employer and the majority of the employees covered under the plan are engaged in a high-risk profession, such as longshore work, these individual's thresholds are increased in 2018. The family coverage amount is increased by $3,450.]

d. Mark, age 58, receives employer-sponsored retiree health coverage from his previous employer. Mark does not receive Medicare. [This answer is incorrect. One exception to the 2018 threshold for employer-sponsored health care coverage is an individual who has attained age 55 and is non-Medicare eligible. The person must also receive employer-sponsored retiree health coverage. This individual is eligible for the increased threshold amount in 2018.]

28. Who is responsible for paying the excise tax on employer-sponsored health care coverage when the group health plan is self-insured? **(Page 59)**

a. The employer. [This answer is incorrect. The employer is responsible for calculating the amount subject to the excise tax allocable to each insurer and plan administrator and for reporting these amounts to each insurer, plan administrator and the IRS, in the form and at the time that the IRS may prescribe, but the employer is not responsible for paying the excise tax when the group health plan is self-insured.]

**b. The plan administrator. [This answer is correct. According to IRC Sec. 4980I(c), for self-insured group health plans, a health FSA or an HRA, the excise tax is paid by the entity that administers benefits under the plan or arrangement (the "plan administrator").]**

29. In 2018, Barbara elects family coverage under a fully-insured major medical policy with a value of $29,500. In addition, Barbara contributes $3,500 to a health FSA. The health cost adjustment percentage for 2018 is 100%, and the age- and gender-adjusted excess premium amount for the employer is $700. What amount is subject to excise tax for Barbara for 2018? **(Page 60)**

a. $0. [This answer is incorrect. Barbara's policy value exceeds the applicable threshold dollar amount indicated in IRC Sec. 4980I(b)(3), so a certain amount would be subject to excess tax in 2018.]

b. $1,300. [This answer is incorrect. In determining the amounts by which the value of employer-sponsored health insurance coverage exceeds the threshold amount, the aggregate value of all employer-sponsored health insurance coverage is taken into account, including coverage in the form of reimbursements under a health flexible spending account (FSA). This calculation does not take into account the health FSA.]

**c. $4,800. [This answer is correct. To calculate the amount subject to excess tax, first add the value of the policy ($29,500) to the value of the health FSA ($3,500). The threshold amount would then need to be calculated. The health cost adjustment percentage for that year is 100%, and the age- and gender-adjusted excess premium amount for the employer is $500. Multiply the 2018 threshold amount by the health cost adjustment percentage and add the excess premium to arrive at the threshold amount ($27,500 × 100% +$700). The threshold amount would then be subtracted from the value of the policy to arrive at the amount subject to excess tax ($33,000 – $28,200).]**

d. $5,500. [This answer is incorrect. This amount does not take into account the increase in the allowable threshold for the age- and gender-adjusted excess premium amount as indicated in IRC Sec. 4980I(b)(3). The tax is equal to 40% of the aggregate value of the health insurance coverage that exceeds: (1) the threshold dollar amount, which is (2) multiplied by the health cost adjustment percentage, and finally (3) increased by the age and gender adjusted excess premium amount.]

## EXAMINATION FOR CPE CREDIT

### Lesson 3

Determine the best answer for each question below. Then log onto our Online Grading Center at **OnlineGrading.Thomson.com** to record your answers.

12. Which of the following would **not** be considered a dependent for health benefits?

    a. A disabled 37-year-old child of a parent with an employer-sponsored health plan.

    b. The child of a child receiving dependent coverage under their mother's employer's health plan.

    c. A 25-year-old dependent child who is a full-time student.

    d. The stepdaughter of an employee who is eligible for an employer-sponsored health plan.

13. Which of the following would be considered an employee for the small employer health insurance credit?

    a. The nanny of the owner of a sole proprietor.

    b. The daughter of the owner in a partnership.

    c. A full-time employee of a small employer with average wages of $36,000 per year.

    d. A full-time employee who is a 2% shareholder of an S corporation.

14. Which of the following would **not** be included in determining the value of employer-sponsored health insurance coverage?

    a. Supplemental liability insurance coverage.

    b. Worker's compensation insurance.

    c. Contributions to a health savings account.

    d. Automobile medical payment insurance.

15. In 2013, Trey has medical expenses of $20,000 and an AGI of $75,000. How much can Trey deduct for medical expenses in 2013?

    a. $5,625.

    b. $7,500.

    c. $12,500.

    d. $19,375.

16. HLB Industries receives a $35 subsidy for retiree drug costs for $150 of eligible drug expenses. Which of the following is true regarding the subsidy or expense?

    a. HLB is permitted a $115 deduction for ordinary business expense.

    b. HLB is allowed a deduction of $150 for the drug expense.

    c. $115 is excludable from income under IRC Sec. 139A for HLB.

    d. HLB is not allowed a deduction for the drug expenses since it received a subsidy.

17. In 2013, Ed a single taxpayer, had net investment income of $150,000 and MAGI of $250,000. What is Ed's additional unearned income Medicare contribution tax for 2013?

    a. $0.

    b. $1,900.

    c. $3,800.

    d. $5,700.

18. Which of the following properly defines the phase-out range for the premium assistance credit?

| Percentage of Income | Percentage of the Poverty Line |
|---|---|
| I. 2.0% | i. 100% |
| II. 3.0% | ii. 200% |
| III. 7.5% | iii. 300% |
| IV. 9.5% | iv. 400% |

    a. I and i; IV and iv.

    b. I and ii; IV and iii.

    c. III and iii; IV and iv.

    d. II and i; III and ii.

19. Beginning in 2014, large employers will be required to report certain information to the IRS. Which of the following is an accurate information request that will be required for large employers?

    a. The number of full-time employees of the employer at the end of the calendar year.

    b. The name, address and taxpayer identification number of each full-time employee hired by the employer in the current calendar year.

    c. A certification explaining that the employer offers its full-time employees and dependents the opportunity to enroll in minimum essential coverage under an eligible employer-sponsored plan.

    d. A list of all health care plans and options offered to employees by the employer for the calendar year.

20. In 2014, Purple Pie Company had 105 full-time employees. Purple Pie failed to offer their employees health insurance with minimum essential coverage. Five of the employees received a tax credit for the year for enrolling in a state exchange program. What is Purple Pie's monthly penalty for 2014?

    a. $12,500.

    b. $17,500.

    c. $150,000.

    d. $210,000.

21. In 2014, Smith Enterprises offers health coverage to its 105 employees. Sixty of the employees receive a tax credit for the year for enrolling in a state exchange-offered plan. What amount of calculated penalty will Smith Enterprises have to pay in 2014 for the employees enrolled in the state exchange-offered plan?

    a. $0.

    b. $150,000.

    c. $180,000.

    d. $315,000.

22. Which of the following individuals is subject to the uninsured penalty for the tax year beginning 2014?

    a. Fiona paid premiums to her employer's health care plan for each month during 2014.

    b. Griffin was unemployed from March 1, 2014, through May 20, 2014, and did not pay health care plan premiums during this time.

    c. Helga was unemployed from July 15, 2014, through November 2014 and did not pay health care plan premiums during this time.

    d. John was unemployed for most of 2014 and paid COBRA premiums.

23. Which of the following is an accurate definition of a "group market" as described in the Health Care Act?

    a. A group market is the health insurance market where individuals obtain insurance on behalf of their dependents through a group health plan maintained by the federal government.

    b. A group market is the health insurance market where individuals obtain insurance on behalf of themselves through a group health plan maintained by an employer.

    c. A group market is the health insurance market where individuals obtain insurance on behalf of their dependents through a group health plan maintained by a large employer.

    d. A group market is the health insurance market where individuals obtain insurance on behalf of themselves through a group health plan maintained by a small employer.

24. Stacy works for High Line Communications, a company that installs telecommunication lines. She is provided with employer-sponsored health insurance. In 2018, what would the threshold amount be for the excise tax imposed on Stacy's health insurance?

    a. $10,200.

    b. $11,850.

    c. $27,500.

    d. $30,950.

25. The growth in the cost of health care from 2010 to 2018 is 59%. What is the new threshold amount for an individual in 2013?

    a. $10,200.

    b. $10,608.

    c. $27,500.

    d. $28,600.

26. When might a penalty be applied to an employer in relation to the excise tax imposed on employer-sponsored health coverage applicable in 2018?

    a. The employer overvalues the aggregate premium of employer-sponsored health coverage.

    b. The employer reports the excise tax to a plan administrator, who remits the excise tax to the IRS.

    c. The employer realizes an error in calculation of excise tax and corrects the issue within 15 days of submitting.

    d. A lower amount than required of insurance cost subject to the excise tax is reported.

# Glossary

**Adjusted Gross Income (AGI)** – All taxable income of an individual filer from whatever sources derived less certain deductions allowed as defined in IRC Sec. 62. AGI is used as a threshold in individual income taxation to calculate eligibility (or phase-out of eligibility) for many deductions, credits, or taxability of specific types of income.

**Alternative Minimum Tax (AMT)** – A tax imposed as a backup to regular tax originally intended to ensure that higher income taxpayers paid their fair share of tax. AMT is separate from, but parallel to, regular tax, and a taxpayer pays the greater of regular tax or AMT.

**Deferred Compensation** – Compensation that will be taxed when received or upon the removal of certain restrictions on receipt and not when earned.

**Dependent** – A qualifying child or qualifying relative of the taxpayer for whom the taxpayer may claim an exemption.

**Depreciation** – Loss in the value of tangible property over the time the property is being used. Deductions can be claimed for this loss if property is used in a trade or business or held for the production of income.

**Economic Substance** – A transaction is treated as having economic substance only if—apart from federal income tax effects—(1) the transaction changes in a meaningful way the taxpayer's economic position; and (2) the taxpayer has a substantial purpose for entering into such transaction. A transaction must satisfy both tests in order for it to be treated as having economic substance.

**Excise Tax** – A type of ad valorem (according to value) tax or *in rem* (on the physical units) tax levied by various levels of government on specified goods or services.

**Fiduciary** – An individual or entity holding a position of trust or confidence. Used here in connection with trusts and estates.

**Full-time Employee** – An employee who is employed on average at least 30 hours of service per week.

**Gross Income** – All income from all sources (other than tax-exempt income) that must be included on a taxpayer's tax return.

**Health Insurance Exchange** – A federally supervised marketplace for health insurance policies meeting specific eligibility and benefit criteria, to be made available not later than January 1, 2014, to qualifying individuals and employer groups of graduated sizes. (Health Care Act Secs. 1311 and 1312))

**Itemized Deductions** – Deductions allowed on Schedule A (Form 1040) for medical and dental expenses, taxes, interest, charitable contributions, casualty and theft losses, and miscellaneous deductions. They are subtracted from adjusted gross income in figuring taxable income.

**Passive Activity** – If the taxpayer does not materially participate in an activity, the income or loss resulting is passive. The passive loss rules limit the amount of losses from passive activities that can reduce income from nonpassive sources. Generally, losses from passive activities in excess of passive income may not reduce nonpassive income (active income and portfolio income). Passive losses that cannot offset other types of income are suspended losses and must be carried forward to offset future passive income.

**Phaseout Ranges** – Income ranges in which certain deductions, credits, and personal exemptions are reduced and eventually eliminated altogether.

**Plan Administrator** – An element of the structure of a typical pension plan, the plan administrator has overall fiduciary responsibility for the operation of the pension fund within the provisions of the plan, regulations, etc. The plan administrator may be a committee of officers or a single individual. For a single-employer plan which has no expenses, it is the employer. The plan administrator may be assisted by actuaries, CPAs, attorneys, etc.

**Premium** – The periodic payment to Medicare, an insurance company or a health care plan for health or prescription drug coverage.

**Principal Residence** – A taxpayer's primary residence that is eligible for gain exclusion if (1) owned for at least two of the previous five years and (2) occupied for at least two of the previous five years, based on the date of sale.

**Qualified Retirement Plan** – A pension, profit sharing or stock bonus trust plan that can provide tax-deferred benefits because it does not discriminate in favor of highly compensated employees and meets a number of other requirements specified by the Internal Revenue Code.

**Qualified Health Plan** – One that meets certain certification requirements, provides "an essential health benefits package," and is offered by an insurer meeting detailed requirements. (Health Care Act Sec. 1301(a))

**Simple Cafeteria Plan** – A cafeteria plan that: (1) is established and maintained by an eligible employer, (2) meets prescribed contribution requirements, and (3) meets prescribed eligibility and participation requirements. (IRC Sec. 125(j)(2))

**Tax Credit** – A tax credit allows a taxpayer to reduce the tax liability dollar for dollar. Hence, a person's marginal tax rate does not affect the tax credit amount.

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# Testing Instructions for Examination for CPE Credit

## 2009 and Spring 2010 Tax Acts (D10TG10)

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To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each lesson, the participant then answers the examination questions and records answers to the examination questions by logging on to the **Online Grading System**. For more information on completing the **Examination for CPE Credit**, see the **Testing Instructions** on the preceding page.

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