

## Get the Latest on IRS Audit Activity

Many clients ask: "How can I avoid being audited by the IRS?" Of course, there's no 100 percent guarantee that a taxpayer won't be picked because some returns are chosen randomly. However, completing tax returns in a timely, orderly, and accurate fashion with a trusted tax adviser certainly works in a taxpayer's favor. It also helps to know the red flags that catch the attention of the IRS.

The overall percentage of taxpayers who are audited is historically around 1 percent, although it varies from year to year. However, certain groups of people and organizations are audited at much higher rates.

We'll tell you about some of the new and recurring audit targets, but first, here are some of the latest collection statistics from the *IRS Data Book* for the fiscal year ending September 30, 2009.

**Individual Returns:** The IRS audited about 1 percent of the 138.8 million individual returns filed. Nearly 23 percent of individual audits were conducted by IRS personnel. The rest were correspondence audits.

Auditors focused heavily on high income taxpayers. For example, 6.4 percent of returns with total positive income of more than \$1 million were audited, a jump from 5.6 percent the year before.

**Corporate Returns:** The tax agency audited 1.3 percent of returns from corporations. Specifically:

- For corporations with assets from \$1 million to \$5 million, audits edged down to 1.8 percent of returns from 2 percent.
- For corporations with assets between \$5 million and \$10 million, audits fell to 2.7 percent from 3.1 percent.
- Audits for corporations with \$10 million or more in assets dropped to 14.5 percent from 15.3 percent.
- The audit percentage for S corporations and partnerships remained unchanged at 0.4 percent of returns.

### Liens and Levies Hurt Revenue Collection?

When the IRS automatically files liens and levies against delinquent taxpayers, it actually hurts the federal government's ability to collect revenue owed. That statement was made in a report to Congress on July 7.

"The conventional wisdom seems to be that more hard-core enforcement actions like liens and levies mean more revenue," Taxpayer Advocate Nina Olson stated. "But the data don't bear that out." Since fiscal year 1999, the IRS has increased lien filings by about 475 percent and levies by about 600 percent. However, inflation-adjusted revenue raised from such efforts has actually declined by about seven percent over that period.

Olson explained that lien filings badly damage a taxpayer's financial viability because they cause the person's credit score to drop about 100 points, and typically remain on a credit record for at least seven years. Employers, mortgage companies, landlords, car dealers, and credit card issuers use credit reports, so a lien can adversely affect a person's ability to obtain and retain a job, purchase or rent a home, and obtain credit.

Accordingly, it can reduce a taxpayer's income or increase expenses, which impairs his or her ability to pay taxes in the future.

So, what's next? Here are some new and recurring areas that are likely to raise red flags:

**Homebuyer Tax Credit** - In a new report from the Treasury Inspector General, the IRS was found to have paid more than \$27 million in fraudulent homebuyer tax credit claims on 2008 returns. Incredibly, approximately 1,300 prison inmates (some serving life sentences) received \$9 million for homes they could not have possibly bought while behind bars.

In response, the IRS plans to scrutinize the returns of taxpayers claiming the homebuyer credit, as well as attempt to recoup money paid erroneously on past claims. There are now special filing requirements that include sending sale-related documents with a tax return claiming the homebuyer credit.

**Online Income** - Starting in 2011, the IRS will be taking a closer look at transactions by sellers on eBay and other online auction sites. This is the result of a new law that requires any bank or other payment settlement company that processes credit cards, debit cards, and electronic payments such as PayPal to report to the IRS what merchants receive. Not all online sales are taxable, as many sell used items at a loss.

**Investment Income** - The IRS often discovers unreported taxable income when its computers compare the income reported on tax returns with the information obtained from financial institutions about dividends and interest.

*Changes Ahead:* Be aware that the IRS will soon receive more information about investors' activities.

Right now, the IRS is informed about how much investors sell securities for, but the tax agency relies on investors to provide the purchase prices.

Beginning with specified securities purchased in 2011, brokers will be required to calculate gains and losses and classify them as short-term or long-term. This information will be reported to customers and the IRS.

The expanded requirements were implemented in response to tax officials' suspicion that many people overstate the tax basis when they sell securities in order to pay less tax.

**Self-Employment Income** – The tax system makes it easier for self-employed individuals (rather than employees) to underreport income and fabricate or overstate deductions. The IRS traditionally expends extra effort to ensure self-employed taxpayers filing Schedule C remain compliant. But there is a new focus after a recent report from the Treasury Inspector General found that even when the IRS audited self employed taxpayers, it failed to address significant potential misreporting of income.

**Automobile Expenses** – Traditionally, this is a high-risk area for business taxpayers. Auditors are suspicious of claims that a personal car is mostly or exclusively used for business. Clients should maintain a daily log of business mileage with odometer readings, dates, locations and purposes of meetings, as well as the names of people they meet with.

**High Itemized Deductions** – If taxpayers' itemized tax deductions exceed IRS ranges for their income group, the odds of an audit jump significantly.

**Home Office Tax Deductions** – As a general rule, the office must be a taxpayer's principal place of business or a place where he or she regularly meets with clients or patients.

**Alimony** – These payments have become an audit target after years of perceived abuses. The IRS matches deductions taken by one former spouse with the taxable alimony income reported by the other.

**Losses from an Activity the IRS Considers a Hobby** – This is another ongoing favorite IRS target and includes activities such as horse breeding and photography. However, taxpayers have effectively fought the IRS by keeping accurate records, following industry practices, and operating at a profit in three out of five consecutive years (two out of seven for horse businesses).

## **IRS Scrutinizing 401(k) Plan Compliance**

The IRS has begun checking compliance with 401(k) plan regulations by asking a random sample of 1,200 plan sponsors to fill out an online questionnaire.

If a company is chosen, failing to accurately complete the document and return it within the 90-day deadline could generate an audit. In announcing the project, the IRS noted that although 401(k)s are the preferred retirement plan for most employers, they are the most non-compliant.

The questions cover the following categories related to 2006, 2007, and 2008:

- Demographics relating to plan features and participation by employees, age, and service restrictions.
- Other plans an organization sponsors.
- Types of employer and employee contributions (such as matching, non-elective, and deferral).
- Non-discrimination testing to determine if a plan is "top heavy" (a majority of assets attributed to key employees).
- Rules for loans and hardship withdrawals.
- Features such as employer stock, foreign investments, and in-kind distributions.
- Types of automatic contribution arrangements and qualified default investment alternatives.
- Designated Roth features, such as rollovers, and the number of participants.
- Voluntary compliance and correction programs.
- Procedures for administering and amending the plan.

## **Get Ready for Onerous New 1099 Reporting Rules**

Businesses and not-for-profit organizations are accustomed to IRS rules that require them to report certain payments on annual Form 1099 information returns. However, the recently enacted healthcare law imposes surprising new reporting requirements. Complying with them may add significantly to an organization's paperwork burden. While the new rules don't apply to payments made before 2012, it's not too early to start gearing up to deal with them.

**Key Point:** For many organizations, the new rules will require issuing 1099s for all sorts of business payments that they never had to worry about before. And the IRS will receive 1099s detailing how organizations spend money on a whole new range of business expenses. However, the healthcare legislation does *not* require Form 1099 reporting of payments that are made for *non-business* reasons.

The IRS is accepting public comments on the rules until September 29, 2010.

## Current Rules in a Nutshell

**Background:** For many years, businesses have been required to report various payments on different versions of Form 1099. For instance, when a business pays \$600 or more during a calendar year to an independent contractor for services, the business must issue the contractor a Form 1099-MISC that reports the amount paid that year. The business must also furnish a copy of the Form 1099-MISC to the IRS. This reporting procedure helps contractors remember to include the payments on their tax returns, and it helps the IRS ensure that income is reported.

Under rules now in effect, other types of payments that businesses must report on Forms 1099 include:

1. Commissions, fees, and other compensation paid to a single recipient when the total amount paid in a calendar year is \$600 or more.
2. Interest, rents, royalties, annuities, and income items paid to a single recipient when the total amount paid in a calendar year is \$600 or more.

When a Form 1099 is required, it must show:

- The total amount for the calendar year;
- The name and address of the payee;
- The tax ID number (TIN) of the payee (For privacy reasons, truncated TINs can be used on 1099s issued to individuals); and
- The payer's contact information and TIN.

If a business doesn't have a payee's TIN, it may be required to institute backup federal income tax withholding at a 28 percent rate on payments under *Internal Revenue Code Section 3406*.

In most cases, these rules apply to payments made by not-for-profit organizations since they are generally considered to be businesses for 1099 reporting purposes.

If a payer *inadvertently* fails to issue a proper Form 1099, the IRS can assess a \$50 penalty. The penalty for each *intentional* failure can be \$100 or more.

### **Reporting Payments to Corporations**

Under current rules, most payments to corporations are exempt from Form 1099 reporting requirements. However, there are a few exceptions. For instance, payments of \$600 or more in a calendar year to an incorporated law firm must be reported on Form 1099-MISC.

### **Reporting Payments for Property**

Under current rules, there is also generally no requirement to issue 1099s to report payments for property (such as merchandise, raw materials, and equipment).

## What Will Change in 2012 and Beyond?

The healthcare legislation makes two big changes to the existing Form 1099 reporting rules and a third change that is hard to assess without further guidance from the IRS.

**First Change: Payments to Corporations Must Be Reported.** Starting in 2012, if a business pays a corporation \$600 or more in a calendar year, it must report the total amount on an information return. Presumably, Form 1099-MISC will be used for this purpose, or the IRS will develop a new form. (Payments to corporations that are tax-exempt organizations will be exempt from this new requirement.)

**Examples:**

- In 2012, a business pays \$30,000 to rent office space from a corporate lessor. Under the new rules that take effect in 2012, the \$30,000 must be reported on a Form 1099.
- A business pays \$2,000 for four employees to attend a seminar in 2012 put on by a corporation. Under the new rules that go into effect that year, the \$2,000 must be reported on a Form 1099.
- Several employees go on a business trip in 2012, and a business pays \$1,500 to a corporate hotel. The \$1,500 must be reported on a Form 1099 for that year.
- In 2012, a business spends \$1,000 at a local restaurant for an employee holiday dinner. The restaurant is operated by a corporation. Under the rules scheduled to become effective that year, the \$1,000 must be reported on a Form 1099.

**Second Change: Payments for Property Must Be Reported.** Starting in 2012, if a business pays \$600 or more in a calendar year to any party (including an individual) as "amounts in consideration for property," it must report the total payments on an information return for that year. The term "property" means computer equipment, office supplies, raw materials, and more. Again, Form 1099-MISC might be used to report affected payments, or a new IRS form might be created.

**Examples:**

- In 2012, a business buys cash registers from a supplier for \$25,000. It also spends \$1,000 at a food and beverage store to buy refreshments for a company party. Later that year, the company pays an individual \$1,500 for an old pickup truck and spends \$750 at an office supply store for copier ink and computer paper. Under the new rules that are scheduled to go into effect in 2012, all these transactions will require the business to issue 1099s.

As you can see, the new requirements to report corporate payments and amounts to buy property will undoubtedly result in the issuance of many millions of additional Forms 1099 each year. (Presumably, payments between related corporations will *not* be exempt.)

*Another burden:* A business must also obtain a TIN from each affected payee to avoid the requirement for backup withholding of federal income tax.

On the other side of the coin, if a business sells property or operates as a corporation, it will have to supply customers with its TIN to avoid backup withholding on payments made to it.

**Third Change: Payments of "Gross Proceeds" Must Be Reported.** Here's where the new upcoming rules get more confusing. Under a third new rule that will take effect in 2012, payments of \$600 or more in "gross proceeds" to a payee in a calendar year must be reported on an information return. At this point, it is unclear what this new reporting requirement is meant to cover. The best guess is that it is meant to cover payments to non-corporate payees, such as restaurants and other small businesses. We are awaiting IRS clarification on this issue.

## **Commissioner Says Credit and Debit Card Payments Will Be Exempt**

Although no official guidance has been issued, IRS Commissioner Douglas Shulman said in a speech to payroll executives that certain payments will be exempt from the reporting requirements.

"We plan to use our administrative authority to exempt from this new requirement business transactions conducted using payment cards such as credit and debit cards," Shulman said. "These transactions will already be covered by reporting requirements on payment card processors (going into effect next year), so there is no need for businesses to report them as well."

## **Action Plan**

Dealing with the new Form 1099 reporting rules is going to be difficult for many organizations -- resulting in an avalanche of paperwork. Businesses will likely have to modify their accounting procedures to capture payee information that will be needed to comply with the new requirements.

*Remember:* TINs must be obtained from vendors to avoid having to institute backup federal income tax withholding on payments made to them. By the same token, a business must ensure that its customers have its TIN to avoid backup withholding on payments made to it.

What if backup withholding does occur on payments made to a business? It must be prepared to track the withheld amounts so it can claim credit for them at tax return time. If a business winds up on either side of the backup withholding rules, it can be a real mess. And with lots more 1099s flying around, the odds of errors rise proportionately.

To compound the problems with the new reporting requirements, many businesses use accounting methods other than the cash basis. In addition, a number of businesses file their returns using reporting periods other than calendar years. In an audit, imagine a business and the IRS attempting to reconcile 1099s with these complications.

Fortunately, the new Form 1099 reporting rules (including any backup withholding implications) don't cover payments made before 2012. So there's still plenty of time to plan for what is likely to be a daunting task.

# **Corporations: Good Time for Tax-Wise Transactions**

As you know, the 2010 federal income tax rate structure is quite favorable for shareholders of closely-held C corporations for these reasons:

- If a company pays a taxable dividend this year, the maximum federal income tax rate is only 15 percent; and
- That same 15 percent maximum rate applies to 2010 corporate payouts or stock sales that generate long-term capital gains.

## **Dividend and Capital Gains Taxes are Almost Certain to Go Up**

With the passage of the massive healthcare bill, odds are the current taxpayer-friendly picture will only last through the end of this year. Unless Congress takes action to extend the status quo, higher taxes on dividends and long-term gains will kick in on January 1, 2011, when the "Bush tax cuts" are scheduled to expire.

Even if the Republicans take back Congress in November, they might not be able to change the tax

outlook anytime soon. Through 2012, the President has stated he would likely veto any tax cuts as the revenue will be needed to help pay for government healthcare.

Here are the specifics about what is likely coming down the pike:

### ***Dividend Taxes***

The maximum federal rate on dividends is scheduled to increase from the current 15 percent to 39.6 percent on January 1. Although the President has promised more than once to limit the maximum rate to 20 percent, that pledge has changed.

Beginning in 2013, the new healthcare legislation will impose an additional 3.8 percent Medicare tax on a high-income individual's net investment income, which is defined to include dividends. That raises the maximum dividend tax rate to at least 23.8 percent for 2013 and beyond. For affected individuals, that's at least a 58.7 percent increase in federal taxes on dividends (23.8 percent is 158.7 percent of 15 percent).

For this purpose, a high-income individual has an adjusted gross income of \$250,000 if married and filing jointly or \$200,000 for single filers.

### ***Taxes on Long-Term Gains***

Starting January 1, 2011, the maximum rate on most long-term capital gains is scheduled to increase from the current 15 percent to 20 percent. And in 2013, the new healthcare legislation will impose an additional 3.8 percent Medicare tax on a high-income individual's net investment income, which is defined to include long-term gains. As with dividends, that means a maximum federal tax rate of at least 23.8 percent for 2013 and beyond. For affected individuals, that amounts to at least a 58.7 percent increase in federal taxes on long-term gains.

Depending on where your clients live, state income tax rate on dividends and long-term gains may be headed higher, too.

### **What Can Your Clients Do?**

Although next year and beyond look grim from a tax perspective, your clients still have some time to take advantage of this year's historically favorable rates. Here are three strategies to consider before the end of 2010:

#### **Strategy 1: Take Dividends This Year**

Let's say a profitable C corporation has a healthy amount of earnings and profits (E&P). The concept of E&P is somewhat similar to the more-familiar financial accounting concept of retained earnings. While lots of E&P indicates a financially successful company, it also creates two unfavorable tax side effects:

1. To the extent the corporation has current or accumulated E&P, corporate distributions to shareholders (including owners and executives) count as taxable dividends. Since the 2010 federal tax rate on dividends cannot exceed 15 percent, dividends received before the end of this year will be taxed lightly compared to what is likely to happen in 2011 and beyond. Therefore, shareholders should weigh the possibility of triggering a manageable current tax bill by taking dividends in 2010 against the possibility of absorbing a much bigger (but deferred) tax hit on dividends they would otherwise plan to take in future years.

2. When a C corporation retains a significant amount of earnings, there's a risk that the IRS will assess the accumulated earnings tax (AET). This tax can potentially be assessed once a corporation's accumulated earnings exceed \$250,000 (or \$150,000 for a personal service corporation). When the AET is assessed, the tax rate is the same as the maximum federal rate on dividends received by individuals. Therefore, the AET rate is also scheduled to jump from the current 15 to 20 percent, starting in 2011 (assuming the President's pledge to keep it at 20 percent rather than 39.6 percent goes through).

Dividends paid in 2010 will be taxed lightly, and they will also reduce a company's accumulated earnings. So they will also reduce or eliminate the company's AET exposure in future years, when the AET rate will probably be at least 20 percent.

## **Strategy 2: Arrange a Low-Taxed Stock Redemption This Year**

Another way to convert theoretical C corporation wealth into cash is with a stock redemption transaction in which a client sells back some or all of his or her shares to the company. (When there are several shareholders, this is a common technique to cash out one or more selected shareholders while the others continue to hold their stakes.)

To the extent of the corporation's current or accumulated E&P, any stock redemption payment is generally treated as a taxable dividend. However, the Internal Revenue Code provides several exceptions to this rule. If one of these exceptions applies, the redemption payment will be treated as proceeds from selling the redeemed shares. In other words, regular stock sale treatment applies.

The distinction between dividend and stock sale treatment may or may not be important to your clients. That's because when dividend treatment applies, the client receives no offset for his or her tax basis in the redeemed shares. In that case, the entire redemption payment may count as taxable dividend income.

In contrast, when stock sale treatment applies, the client has capital gain (probably long-term) only to the extent the redemption payment exceeds his or her basis in the redeemed shares. So only part of the redemption payment is taxed. In addition, the client can offset capital gain from a redemption treated as a stock sale with capital losses from other transactions (including capital loss carryovers the client may have left over from the 2008 stock market meltdown).

If a client doesn't have significant basis in the redeemed shares or significant capital losses, there's usually only a minor distinction between dividend treatment and stock sale treatment under today's federal income tax system. For 2010, both dividends and long-term capital gains are taxed at the same rates, with a maximum rate of only 15 percent.

However, as explained earlier, both dividends and long-term gains will almost certainly be taxed at higher rates in 2011 and beyond. Therefore, a stock redemption that is completed in 2010 could result in a much lower tax bill than a redemption that's put off until 2011 or later.

## **Strategy 3: Sell Stock This Year**

Speaking strictly from a federal income tax rate perspective, selling shares this year and paying no more than 15 percent on the resulting gains (assuming the taxpayer has held the shares for more than a year) sure beats paying 23.8 percent (or maybe more) on gains from sales in later years.

**Exception:** A taxpayer might want to defer capital gains until the following year because of a reasonable expectation that he or she will be experiencing capital losses at that time that could offset the gains.

Clients should consider the possible advantages of taking dividend payments, transacting stock redemptions, or selling shares in a closely-held corporation under today's favorable federal income tax structure. Waiting until next year or later could prove costly.

## Year-by-Year Summary of Healthcare Law Tax Changes

The *Patient Protection and Affordable Care Act* and the related *Health Care and Education Reconciliation Act* (which are collectively referred to as the healthcare legislation) were signed into law in March. Lots of tax changes are included in the laws. Some have nothing to do with healthcare, some won't kick in for several years, some are effective right now, and some are even retroactively effective.

This chart briefly summarizes some of the most important tax changes, organized by the year when they become effective. (Of course, there will be some clarifications, technical corrections, and IRS guidance to follow.)

<b>RETROACTIVE CHANGES TAKING EFFECT BEFORE 2010</b>		
Tax Change	Description	Effective Date/Tax Code or Law Section
<b>Exclusion for Certain Forgiven Student Loans</b>	A new, retroactive federal income tax exclusion for student loan amounts paid off or forgiven under certain state loan repayment/forgiveness programs intended to increase the presence of healthcare professionals in underserved areas.	Amounts received or forgiven in tax years after 2008.  IRC Section 108(f)(4)
<b>Therapeutic Discovery Projects</b>	A new, retroactive tax credit for qualified investments in therapeutic discovery projects, as defined in the law. Only available to taxpayers with 250 or fewer employees.	Eligible expenses paid or incurred in 2009 and 2010 (\$1 billion limit on total credits allowed).  IRC Section 48D
<b>CHANGES TAKING EFFECT IN 2010</b>		

<p><b>New Health Insurance Tax Credit for Small Employers (Including Not-for-Profit Organizations)</b></p>	<p>Qualifying small employers can claim a new credit to cover up to 35 percent of the cost of health insurance for employees.</p> <p>Qualifying small employers that are tax-exempt non-profits can claim credits to cover up to 25 percent of employee health insurance. A qualifying small employer is one that has no more than 24 full-time-equivalent (FTE) workers; pays an average FTE wage of less than \$50,000; and has a qualifying healthcare arrangement in place.</p> <p>A qualifying arrangement requires employers to: pay at least 50 percent of the cost of each enrolled employee's coverage and pay the same percentage for all employees (even those with more-expensive family or self-plus-one coverage).</p> <p>However, for tax years beginning in 2010, a favorable transition rule allows the credit to be claimed when the employer doesn't pay the same percentage for each enrolled employee but instead pays an amount equal to at least 50 percent of the cost of single coverage (even if an employee has more-expensive coverage). The allowable credit is quickly reduced under a complicated phase-out rule when the employer has more than 10 FTE employees or the average FTE wage is in excess of \$25,000.</p>	<p>Tax years beginning in 2010-2013. The credit can be claimed for eligible costs incurred in tax years beginning in 2010 before the healthcare law was enacted.</p> <p>IRC Sections 45R, and <i>IRS Notice 2010-44</i></p> <p>For more information from the IRS: <a href="#">Small Business Healthcare Tax Credit: Frequently Asked Questions.</a></p>
<p><b>Healthcare-Related Tax Breaks Granted to Adult Children</b></p>	<p>Effective for plan years after September 22, 2010, health plans that cover dependent children <i>must</i> continue to cover adult children until they turn 26. (Plans may voluntarily provide coverage before that.)</p> <p>In conjunction, employer-provided health coverage for an employee's adult child is now treated as a tax-free fringe benefit as long as the child hasn't reached age 27 by year end. It doesn't matter if the adult child is the employee's dependent or not.</p> <p>The IRS has stated that tax-free treatment also applies to reimbursements from an employer-provided cafeteria plan, healthcare flexible spending account (FSA) plan, or health reimbursement arrangement (HRA) to cover an under-age-27 adult child's qualified medical expenses.</p> <p>For self-employed people who pay their own health coverage, the cost of covering an adult child is eligible for the above-the-line deduction for self-employed health premiums, as long as the adult child hasn't reached age 27 by year end (regardless of whether the child is a dependent).</p> <p>There is a discrepancy between the age-26 coverage requirement and the age-27 tax breaks.</p>	<p>March 30, 2010</p> <p>IRC Sections 105(b) and 162(l)</p> <p><i>IRS Notice 2010-38</i></p>
<p><b>Liberalized Adoption Tax Breaks</b></p>	<p>Increases the annual cap on tax-free employer adoption assistance payments by \$1,000 and extends it through 2011. For 2010, this change increases the cap to \$13,170 (up from \$12,170).</p> <p>Similarly, the healthcare legislation increases the maximum annual adoption credit by \$1,000 and extends the new deal through 2011. For</p>	<p>Tax years beginning in 2010 and 2011.</p> <p>IRC Sections 36C and 137</p>

	<p>2010, this increases the maximum credit to \$13,170 (up from \$12,170).</p> <p>Also, for 2010 and 2011, the adoption credit becomes refundable so it can be collected in full even if a client doesn't owe federal income tax.</p>	
<b>New Rules for Not-for-Profit Hospitals</b>	Establishes new rules for hospitals to qualify for tax-exempt non-profit status.	<p>Tax years after March 23, 2010.</p> <p>IRC Sections 501(r) and 6033(b)</p>
<b>No More Tax Credit for "Black Liquor"</b>	Disallows the cellulosic biofuel producer credit for so-called black liquor fuels.	<p>Fuels sold or used after 2009.</p> <p>IRC Section 40(b)(6)(E)</p>
<b>New Loss Ratio Rule for Health Organizations</b>	Requires a medical loss ratio of at least 85 percent for health organizations to qualify for certain insurance company tax breaks.	<p>Tax years after 2009.</p> <p>IRC Section 833</p>
<b>New Tanning Tax</b>	Imposes a 10 percent excise tax on indoor tanning services.	<p>Services after June 30, 2010.</p> <p>IRC Section 5000B</p>
<b>Economic Substance Doctrine is Codified</b>	<p>The legislation attempts to provide a home in the tax code for the economic substance doctrine. It will be deemed to exist only if the transaction in question changes the taxpayer's economic position in a meaningful way without regard to tax consequences and is entered into for a substantial non-tax purpose. A 20 percent penalty can be assessed on tax underpayments attributable to transactions that are disallowed because they lack economic substance. The penalty rises to 40 percent for "undisclosed economic substance transactions." Other penalties may also apply.</p>	<p>For transactions entered into after March 30, 2010, and tax underpayments, understatements, refunds, and credits attributable to transactions entered into after that date.</p> <p>IRC Sections 7701(o), 6662(i), and 6676(c)</p>
<b>CHANGES TAKING EFFECT IN 2011</b>		
<b>Employer Must Report Healthcare Costs on Forms W-2</b>	Requires employers to report to employees on their annual W-2 forms the value of employer-provided health insurance coverage (not including salary-reduction amounts contributed to healthcare flexible spending accounts).	<p>Tax years after 2010.</p> <p>IRC Section 6051(a)(14)</p>
<b>No More Tax-Free Reimbursements for Non-Prescription Drugs</b>	For participants in an employer-sponsored healthcare FSA or HRA or their own health savings account (HSA) or medical savings account (MSA), current rules allow tax-free withdrawals to pay for non-prescription drugs like pain and allergy relief medications. Starting next year, this tax-favored treatment will only be available for prescription drugs, insulin, and doctor-prescribed over-the-counter medications.	<p>For expenses incurred in tax years beginning after 2010.</p> <p>IRC Sections 106(f), 220(d), and 223(d)</p>
<b>Stiffer Penalty on Non-Qualified HSA and MSA Withdrawals</b>	If a taxpayer takes money out of an HSA or MSA for any reason other than to cover qualified medical expenses, the current rules say he or she will usually owe federal income tax plus a 10 percent penalty tax, or a 15 percent penalty tax	<p>Withdrawals in tax years beginning after 2010.</p> <p>IRC Sections. 220(f) and 223(f)</p>

	for an MSA. The new law increases the penalty to 20 percent for non-qualified withdrawals.	
<b>New Simple Cafeteria Plans for Small Employers</b>	Establishes a new and simpler Section 125 cafeteria benefit plan for employers with 100 or fewer employees. These plans will be deemed to automatically satisfy all applicable cafeteria benefit plan non-discrimination rules if they satisfy certain minimum standards for eligibility, participation, and contributions.	Tax years beginning after 2010.  IRC Section 125(j)
<b>New Tax on Drug Companies</b>	Imposes a new non-deductible fee on manufacturers and importers of branded prescription drugs. Each company must pay an allocable portion of the total annual fee, which is \$2.5 billion for 2011. The fee is apportioned among targeted companies based on each company's share of sales in the preceding year.	Calendar year 2011.  Section 9008 of the <i>Patient Protection Act</i>
<b>CHANGES TAKING EFFECT IN 2012</b>		
<b>New 1099 Reporting Requirement for Business Payments to Corporations</b>	In general, a business that pays \$600 or more in a calendar year to a corporation must supply the corporation with a Form 1099 and file a copy with the IRS.	For payments made after 2011.  IRC Section 6041(a)/(h)
<b>New 1099 Reporting Requirement for Business Payments for Property</b>	A business that pays \$600 or more in a calendar year to a single payee (including an individual) for property generally must supply a Form 1099 and file a copy with the IRS. Before this, payments by businesses for property (as opposed to payments for services) were generally exempt from 1099 reporting requirements.	For payments made after 2011.  IRC Section 6041(a)
<b>New Tax on Health Insurance Policies</b>	Health insurers and sponsors of applicable self-insured health plans must pay an annual fee of \$2 per covered life (\$1 per life for affected policy or plan years that end by September 30, 2013).	Policy years ending after September 30, 2012.  IRC Sections 4375, 4376, and 4377
<b>CHANGES TAKING EFFECT IN 2013</b>		
<b>Additional 0.9 percent Medicare Tax on Salaries and Self-Employment Income Earned by Higher Income Taxpayers</b>	<p>Now, the Medicare tax on salary and/or self-employment (SE) income is 2.9 percent (1.45 percent withheld from employee paychecks, and the other half paid by the employer. Self-employed people pay the whole 2.9 percent).</p> <p>Starting in 2013, an extra .9 percent Medicare tax will be charged on:</p> <ul style="list-style-type: none"> <li>• Salary and/or SE income above \$200,000 for an unmarried individual;</li> <li>• Combined salary and/or SE income above \$250,000 for a married joint-filing couple; and</li> <li>• Salary and/or SE income above \$125,000 for those who use married filing separate status.</li> </ul> <p>These thresholds will not be adjusted for</p>	<p>Tax years beginning after 2012.</p> <p>IRC Sections 164(f), 1401(b), 3101(b), 3102, and 6654</p>

	<p>inflation. For self-employed people, the additional .9 percent Medicare tax hit will come in the form of a higher SE tax bill. However, the additional .9 percent will <i>not</i> qualify for the above-the-line deduction for 50 percent of SE tax. (The additional .9 percent Medicare tax must be taken into account for estimated tax purposes.)</p>	
<p><b>Additional 3.8 percent Medicare Tax on Net Investment Income Collected by High Income Folks and Trusts</b></p>	<p>Now, the maximum federal tax rate on long-term capital gains and dividends is 15 percent. In 2011, the top rate is scheduled to go up as the "Bush tax cuts" expire. Starting in 2013, all or part of the net investment income, including long-term capital gains and dividends, collected by high-income folks can get hit with a 3.8 percent "Medicare contribution tax." Therefore, the top federal rate on long-term gains and dividends for 2013 and beyond will be 23.8 percent.</p> <p>The additional 3.8 percent Medicare tax won't apply unless modified adjusted gross income (MAGI) exceeds: \$200,000 for an unmarried individual; \$250,000 for married joint-filers; or \$125,000 for married filing separately. These thresholds won't be adjusted for inflation.</p> <p>The additional 3.8 percent Medicare tax will apply to the <i>lesser</i> of: net investment income or MAGI in excess of the applicable threshold.</p> <p>Net investment income includes interest, dividends, royalties, annuities, rents, gross income from passive business activities, gross income from trading in financial instruments or commodities, and net gain from property held for investment (but not for business purposes) reduced by deductions allocable to such income.</p> <p>The additional Medicare tax must be taken into account for estimated tax payment purposes.</p> <p>For a trust, the extra 3.8 percent Medicare tax will apply to the <i>lesser</i> of: undistributed net investment income or the AGI in excess of the threshold for the top trust federal tax bracket.</p>	<p>Tax years beginning after 2012.</p> <p>IRC Sections 1411 and 6654</p>
<p><b>New \$2,500 Cap on Healthcare FSA Contributions</b></p>	<p>Now, there's no tax-law limit on salary-reduction contributions to an employer healthcare FSA (although many impose their own annual limits). Starting in 2013, the maximum annual FSA contribution by an employee will be capped at \$2,500. Then, the cap will be indexed for inflation.</p>	<p>Tax years beginning after 2012.</p> <p>IRC Section 125(i)</p>
<p><b>Higher Threshold for Itemized Medical Expense Deductions</b></p>	<p>Taxpayers can now claim an itemized deduction for medical expenses paid for themselves, a spouse, and dependents, to the extent the expenses exceed 7.5 percent of AGI. Starting in 2013, the hurdle is raised to 10 percent of AGI. But if the taxpayer or spouse is age 65 or older at year end, the new 10 percent-of-AGI threshold will not take effect until 2017. The medical deduction threshold for AMT purposes remains at 10 percent of AGI.</p>	<p>Tax years after 2012 (2016 if taxpayer or spouse is 65 or older at year end).</p> <p>IRC Section 213(a) and (f)</p>

<p><b>No Deductions for Retiree Drug Subsidies</b></p>	<p>Employers sponsoring qualified retiree prescription plans are entitled to collect tax-free federal subsidies for part of the cost. Employers can now deduct the full cost of retiree drug plans without any reduction for the tax-free federal subsidies. In effect, deductions are allowed for amounts that are actually paid by the government. The healthcare law reduces deductions by the amount of tax-free federal subsidies.</p>	<p>Tax years beginning after 2012.  IRC Section 139A</p>
<p><b>New Excise Tax on Medical Device Manufacturers</b></p>	<p>Manufacturers have to pay a 2.3 percent excise tax on taxable sales of medical devices for humans. However, devices retailed to the general public will be exempt. The tax will not apply to eyeglasses, contact lenses, hearing aids, etc.</p>	<p>Sales after 2012.  IRC Section 4191</p>
<p><b>New Deductible Compensation Limit for Health Insurers</b></p>	<p>Affected health insurance providers face a \$500,000 per-person deduction limit on compensation paid to "applicable individuals," which can include officers, employees, directors, and certain other providers such as consultants.</p>	<p>Tax years beginning after 2012.  IRC Section 162(m)(6)(A)</p>
<p><b>CHANGES TAKING EFFECT IN 2014</b></p>		
<p><b>New Penalties on Individuals without "Adequate" Coverage</b></p>	<p>In general, U.S. citizens and legal residents will pay penalties if they don't obtain "adequate" health insurance coverage.</p> <p>The <i>tentative</i> penalty will equal the <i>greater</i> of: the applicable percentage of household income above the threshold that requires filing a federal income tax return; or the applicable dollar amount times the number of uninsured individuals in the household. The applicable income percentage is 1 percent for 2014, 2 percent for 2015, and 2.5 percent for 2016 and beyond.</p> <p>The applicable dollar amount is \$95 for 2014, \$325 for 2015, and \$695 for 2016. After that, the \$695 amount will be adjusted for inflation. For under-age-18 household members, the applicable dollar amounts will be 50 percent of the aforementioned amounts.</p> <p>The <i>final</i> penalty amount for each household will be limited to 300 percent of the applicable dollar amount. For example, the maximum 2016 penalty will be \$2,085 (three times \$695). However, if the national average cost of "bronze coverage" (a new term of art) for the household is less, the maximum penalty will be limited to the cost of bronze coverage.</p> <p>If an affected individual is uninsured for only part of the year, the penalty will be calculated monthly using pro-rated figures.</p>	<p>Tax years beginning in 2014.  IRC Section 5000A</p>

<p><b>New Penalties on Employers</b></p>	<p>Employers with at least 50 full-time employees that do not provide affordable health coverage that meets certain minimum standards will be charged a non-deductible penalty if even one full-time employee purchases government-subsidized coverage through a state-run exchange.</p> <p>Government-subsidized coverage means coverage for which a federal cost-sharing subsidy (explained below) is available.</p> <p>The penalty will be \$167 per month (\$2,000 per year) for each employee who is not provided with "adequate" coverage for that month (even if a particular employee purchases subsidized coverage from a state-run exchange). However, no penalty is charged for the first 30 employees.</p> <p>An employer can still owe penalties even when employees are offered the opportunity to enroll in a plan that provides minimum essential coverage, but one or more employees choose to instead buy subsidized coverage through a state-run exchange. In this case, the penalty is \$250 per month for each applicable employee, but the total cannot exceed the penalty that would be charged for outright failure to offer "adequate" coverage.</p>	<p>Coverage months beginning in 2014.</p> <p>IRC Section 4980H</p>
<p><b>New "Cost-Sharing Subsidies" for Eligible Individuals</b></p>	<p>Government paid "cost-sharing subsidies" will be provided to help individuals ineligible for Medicaid, employer-provided coverage, or other "adequate" coverage. This has been explained as a low-income benefit, but a person can be eligible with income up to 400 percent of the federal poverty level. (For 2009, this was \$43,320 for one person or \$88,200 for a family of four.)</p> <p>The cost-sharing subsidy is sometimes called a "premium assistance tax credit," because there is language in the tax code. In most cases, however, the subsidy will be paid directly to the insurer. If that doesn't happen, the subsidy amount can be claimed as a refundable tax credit on the eligible individual's federal tax return.</p>	<p>Tax years beginning in 2014.</p> <p>IRC Section 36B</p>
<p><b>More Generous Health Insurance Tax Credit for Small Employers</b></p>	<p>As explained in the 2010 changes, qualifying small employers can claim a credit to help cover the cost of providing employee health coverage. For 2010-2013, the maximum credit percentage is 35 or 25 percent for tax-exempt employers. Starting in 2014, the maximum credit percentage increases to 50 or 35 percent for tax-exempt employers. However, employers must purchase qualifying health coverage from state-run insurance exchanges to be eligible for the higher credit percentages. Also, the FTE wage caps for credit qualification and calculation purchases are indexed for inflation, starting in 2014.</p>	<p>Tax years beginning in 2014.</p> <p>IRC Section 45R and Section 1421 of the healthcare legislation.</p>
<p><b>Some Employers Must Give "Free Choice Vouchers"</b></p>	<p>An affected employer must give a "free choice voucher" to any eligible employee who chooses to buy his or her own coverage instead of participating in the company plan. The voucher amount equals what the employer would have contributed on behalf of the employee if he or</p>	<p>Calendar year 2014.</p> <p>Section 10108 of the healthcare legislation.</p>

	she participated. As long as the employee spends at least the amount of the voucher on qualified health coverage, the voucher is tax-free to the employee. However, an employee who takes advantage of the voucher is ineligible to receive any cost-sharing subsidy for buying coverage from a state-run exchange.	
<b>New Excise Tax on Health Insurance Providers</b>	A new fee is imposed on health insurance providers. Each targeted company must pay an allocable portion of the total annual fee, which is \$8 billion for 2014. The fee is apportioned among targeted companies based on each company's share of applicable net premiums.	Calendar year 2014.  Section 9010 of the <i>Patient Protection Act</i> .
<b>CHANGE TAKING EFFECT IN 2018</b>		
<b>New Excise Tax on "Cadillac Health Plans"</b>	Health insurance companies that service the group market and administrators of employer-sponsored plans will get socked with a 40 percent excise tax on premiums that exceed the applicable threshold of \$10,200 for self-only coverage or \$27,500 for family coverage. For retirees and plans that cover employees in high-risk professions, the thresholds will be \$11,850 and \$30,950, respectively. These thresholds may be increased to reflect higher-than-expected inflation in health premiums. Plans sold in the individual market will be exempt, except for coverage eligible for the above-the-line deduction for self-employed health premiums.	Tax years beginning in 2018.  IRC Section 4980I