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## KPM Newsletter

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### Impact of the New Health Care Law

The debates about health care reform are over -- at least for now. The *Patient Protection and Affordable Care Act* was finally signed into law by President Obama in March. The wide-ranging legislation, and its accompanying reconciliation law, will significantly change the face of health care for employers and many individuals.

The changes generally take effect over time. In some cases, you won't see them for two to four years. However, advance planning can maximize tax advantages for some and minimize tax disadvantages for others. In addition to virtually mandating health coverage for all citizens in the United States, the massive law includes significant tax changes.

Here is a brief summary of some provisions in the legislation and how your clients might be affected.

#### Individual Coverage

This is one of the foundations of the health care legislation. For tax years beginning after 2013, any individual who is not eligible for Medicare or Medicaid must obtain "minimum essential coverage" through an employer-sponsored plan or one of the other options, such as a govern-

ment-sponsored plan or a private plan. If he or she fails to do so, a non-deductible tax penalty will be assessed based on the greater of a flat dollar amount (cut in half for children under age 18 or full-time students) or a percentage of household income.

These figures will be phased in over three years. In 2014, the flat dollar penalty is \$95 per adult or 1 percent of household income, if greater. The penalty increases to \$325 in 2015 (or 2 percent of household income) and \$695 in 2016 (or 2.5 percent of household income). After that, it will be adjusted for inflation. However, there is a limit on how much a family with several individuals will be penalized. The total household penalty cannot exceed 300 percent of the per-adult penalty.

#### Premium Assistance Credits

For tax years beginning after 2013, the new law provides "premium assistance credits" that certain taxpayers can use to help purchase health insurance through a state-run exchange. Eligibility for this refundable tax credit will be based on household income in the tax year ending two years before the enrollment period.

The credit is generally available to taxpayers with a household income between 100 percent and 400 percent of the federal poverty level who aren't receiving health insurance through an employer (or spouse's employer). This credit is coordinated with reduced cost-sharing for qualified individuals.

#### Employer Responsibilities

For tax years beginning after 2013, an employer may have to pay a tax penalty if it fails to offer minimum essential coverage to an eligible employee. The penalty for each month is equal to the number of full-time employees multiplied by one-twelfth of \$2,000.

This rule applies to any employer with at least 50 full-time employees during the prior calendar year.

*Note:* The penalty is based on *all* full-time employees, not just employees who aren't receiving minimal essential coverage. But an employer can subtract the first 30 employees from the calculation. For instance, the penalty for an employer with 100 full-time employees is based on 70 employees.

#### Small Business Credits

The new requirements for em-

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employers may be costly, but qualified small business owners can benefit from a special tax credit. The maximum credit is 35 percent of premiums paid in 2010 by eligible small business employers and 25 percent of premiums paid by eligible employers that are tax-exempt organizations. In 2014, this maximum credit increases to 50 percent of premiums paid by eligible small business employers and 35 percent of premiums paid by eligible employers that are tax-exempt organizations.

The credit is specifically targeted to help small businesses and tax-exempt organizations that primarily employ low and moderate income workers. It is generally available to employers that have fewer than 25 full-time equivalent (FTE) employees paying wages averaging less than \$50,000 per employee per year. Because the eligibility formula is based in part on the number of FTEs, not the number of employees, many businesses will qualify even if they employ more than 25 individual workers.

The maximum credit goes to smaller employers -- those with 10 or fewer FTEs -- paying annual average wages of \$25,000 or less.

Eligible small businesses can claim the credit as part of the general business credit starting with the 2010 income tax return they file in 2011.

### Medicare Tax

The new law includes a fundamentally different tax treatment in the imposition of the 1.45 percent Medicare tax paid by individuals (2.9 percent for self-employed individuals). Previously, this payroll tax only applied to "earned income," such as wages and bonuses. No part of the Social Security tax, including the Medicare tax, was ever due on "unearned income" received from investments. For tax years beginning after

2012, certain high-income taxpayers may be assessed an additional tax on earned income and an unprecedented Medicare tax on unearned income.

### New Reporting Requirements

For tax years beginning after 2011, the new law requires employers to report the value of the employer-sponsored health insurance coverage on employees' W-2 forms. It also requires businesses to file information returns for all payments totaling \$600 or more in a calendar year to a single recipient, including corporations (other than tax-exempt entities). Additional details on these requirements will be issued in the future by the IRS.

### High Earners Face Two New "Payroll" Taxes

The *Patient Protection Act* imposes two new extra Medicare taxes on high-income individuals beginning in 2013:

1. A taxpayer must pay an additional 0.9 percent Medicare tax on earned income if he or she is a single tax filer with earned income above \$200,000 or a joint filer with earned income above \$250,000.
2. A taxpayer must pay an additional 3.8 percent Medicare tax on net investment income if he or she is a single tax filer with a modified adjusted gross income (MAGI) above \$200,000 or a joint filer with a MAGI of more than \$250,000.

The second tax applies to "net investment income." For this purpose, net investment income includes interest, dividends, royalties, rents, gains from dispositions of property, and passive activity income (from, for example, certain rentals). However, it does not include distributions from qualified retirement plans, such as 401(k), 403(b) and 457 plans, and IRAs.

The tax on net investment income is as-

essed on the lesser of the net investment income or the amount by which a taxpayer's net investment income exceeds the MAGI threshold.

**Example:** Let's say in 2013, a client receives \$220,000 in wages, \$70,000 in capital gains, and \$10,000 in IRA distributions, for an MAGI of \$300,000. Because he is a joint filer and his MAGI exceeds the threshold by \$50,000, he must pay the additional Medicare tax on \$50,000 of his capital gains, or an extra \$1,900 (\$50,000 times 3.8 percent). However, he doesn't owe the extra 0.9 percent tax because his earned income doesn't exceed the \$250,000 threshold.

### Provisions That May Affect Clients and Their Children

These two provisions take effect six months from the date of enactment:

**Pre-existing conditions** - The *Patient Protection Act* prohibits health plans from denying coverage to children who have pre-existing conditions.

**Coverage for young adults** - The law generally requires health plans to allow parents to keep their children on their insurance policies through age 26.

**Increased Tax Break for Adoptions** - The tax credit for adoption expenses is increased \$1,000 to \$13,170 for 2010. The credit is also now refundable. That means that an eligible taxpayer can collect all or part of any leftover credit after his or her federal income tax has been reduced to zero.

There are numerous other tax provisions in the new health care law, including changes for cafeteria plans, flexible spending accounts, and other tax-favored health care accounts; and fees on insurers for high-cost insurance plans. Other special rules and "grandfather" exceptions for health plans may apply.

## Improving the Effectiveness of Audit Committees

As the economy recovers, companies and not-for-profit organizations are faced with a host of new challenges. In order to prepare for those challenges and the risks they will create, audit committees should consider taking the following eight steps:

- 1. Get Back to Basics.** During the past 18 months, the recession has likely dominated the agenda of audit committees. They should consider revisiting the goals and expectations and develop an agenda that directs the committee's focus back to the fundamentals. An audit committee is typically responsible for oversight of financial reporting, disclosures, internal controls, and the company's audit process. Therefore, each agenda item before the audit committee should ideally relate to one of these four areas.
- 2. Assess the Composition of the Audit Committee.** Periodically, it is appropriate to assess the level of financial expertise that each member of a committee possesses, especially if the composition of the group has recently changed. If the company anticipates significant changes in the regulatory environment, now may be the time to add suitably qualified members to the audit committee. At least one member should possess in depth financial expertise. (Publicly traded companies have specific "financial literacy" requirements.)  
  
If the company is heavily regulated, or subject to complex accounting policies and other requirements, it is prudent to require at least two members of the audit committee to have auditing or in-depth accounting experience.
- 3. Get a Handle on Operational Risk.** The company's risk profile may have changed in light of decisions made during the recession. For example,

cutting staff or deferring capital investments might have been wise and appropriate a year ago. However, these decisions may now adversely affect the company's long-term financial performance. The committee should consider asking management to review significant operational decisions made in the last 12 months in order to determine if excess risk was created.

- 4. Revisit Accounting Policies and Plan for Upcoming Changes.** Any revisions in accounting policies at the company that took place in the last 12 to 18 months should now be reviewed in greater detail. (It may not have been feasible during the recession.) Ideally, the audit committee should also take time to review significant proposed changes that are likely to impact the company in the next year to 36 months.

For example, International Financial Reporting Standards will require considerable time, effort, and expense to adopt. Determining whether the finance function has the appropriate expertise and resources to support IFRS is an important step to ensuring successful implementation. In addition, it is beneficial for audit committee members to begin developing an understanding of IFRS.

- 5. Consider Exposure to Companies Experiencing Financial Difficulties.** The effects of a recession can take years to ripple through an economy. Suppliers, as well as customers, may still be experiencing those effects. The committee should ensure that management has identified the company's material relationships and the potential financial and operational impact if any of those businesses go under.
- 6. Review All Disclosure Sources.** In

addition to regular financial reporting, companies use a myriad of resources to disclose information. For example, they may issue press releases and post announcements on their Web sites. But many companies also now have a presence on online social networking sites, such as Facebook, Twitter and LinkedIn, which tend to involve fewer controls than traditional disclosures. Collectively, these sites reach millions of people. It is extremely important that social networking tools are used appropriately and that the information being shared is accurate and consistent with the company's perspective.

- 7. Focus on Fraud.** As a result of the recession, and the related cost cutting, there may be an increased risk of internal and external fraud, including the theft of intellectual property. It is a good time for businesses to request that internal auditors commission a fraud risk assessment. Proactively assessing fraud risks can dramatically reduce the probability of losses occurring.
- 8. Consider Conducting a Review of Significant Findings** uncovered by the company's internal audit department during the last 12 to 18 months, as well as the resulting steps taken by the management to address those issues. Not only will this exercise potentially uncover unresolved issues, it will provide the audit committee with a "pulse check" on the company's sense of urgency regarding the ability of risk mitigation and internal audits to address and track issue resolution.

More Questions for Audit Committees to Ask to Improve Effectiveness

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- Does the committee have an appropriate number of qualified members considering the size, structure, and complexity of the organization? A company listed on the New York Stock Exchange must have an audit committee with a minimum of three members, but it may be prudent to increase the group beyond this required number.

- Does the committee have unrestricted access to the organization's documents and the personnel?
- Before a meeting, are the agenda and other relevant written materials distributed to members so they have enough time to properly address the issues?
- After a meeting, are the minutes distributed to everyone on a timely basis?

By answering these questions and taking the above steps, an audit committee can help improve performance as the economy recovers. It's a good time to examine whether recession cost cutting in technology, staffing, marketing, and operations can be sustained or whether infrastructure elements should be restored.



## Two Tax Breaks in the New HIRE Act

President Obama signed the new *Hiring Incentives to Restore Employment Act* (HIRE) into law on March 18, 2010. This federal legislation creates brand-new tax breaks for hiring and retaining unemployed workers and extends the enhanced Section 179 business equipment deduction that was available last year.

Here's a quick rundown of these key tax breaks.

### Employers Get a Payroll Tax Holiday for New Hires—Plus a Potential Bonus

Normally, an employer is required to pay its share of Social Security taxes on wages earned by employees. For 2010, the portion of the tax is 6.2 percent on the first \$106,800 of wages.

Under the *HIRE Act*, an employer is effectively excused from paying its share -- 6.2 percent tax on wages received by "qualified employees." This exemption applies to wages paid after February 3 through the end of 2010. The maximum value for each qualified employee is \$6,621.

**Example:** If a qualified employee is hired in March and receives \$50,000 in wages in 2010, the employer saves \$3,100 (6.2 per-

cent of \$50,000) in Social Security tax.

The new law defines a "qualified employee" as someone who meets all of these criteria:

- Begins work after February 3, 2010, and before January 1, 2011.
- Has not been employed for more than 40 hours during the previous 60 days (ending on the start date).
- Was not hired to replace another employee unless the former employee separated from employment voluntarily or for cause.
- Is not related to the employer and does not own more than 50 percent of the business, either directly or indirectly.

**Note:** A qualified employee may be either a full-time employee or a part-time employee. There is no minimum requirement for the hours worked. The payroll tax forgiveness does not apply to the 1.45 percent Medicare portion of payroll tax. Also, household employers (for example, hiring nannies) cannot claim the new tax benefit.

The exemption officially begins with wages paid in the second calendar quarter of 2010. Employers entitled to tax relief for the first quarter will be credited against

their general Social Security liability for the second quarter.

**Another tax credit bonus:** In addition to the payroll tax forgiveness, an employer can claim a tax credit if it retains a qualified worker for a minimum of 52 consecutive weeks. The credit is equal to the lesser of \$1,000 or 6.2 percent of the employee's wages paid during the 52-week period. If the employee quits or is fired before the end of the one-year period, no credit is allowed.

The new law requires that employers get statements from each eligible new hire certifying that he or she was unemployed during the 60 days before beginning work

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On its website [www.irs.gov](http://www.irs.gov), the IRS has revised and updated Forms W-2 and W-3 for 2010 to reflect the 2010 payroll tax holiday, for employers that hire unemployed workers, as created by the HIRE Act.

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or, alternatively, worked fewer than 40 hours for someone else during the period.

The IRS released a new form to get the statements and meet this requirement. Form W-11, *Hiring Incentives to Restore Employment Act Employee Affidavit*, is now posted at [www.irs.gov](http://www.irs.gov).

Though employers need this certification to claim both the payroll tax exemption and the new hire retention credit, they do not file these statements with the IRS. Instead, they must retain them along with other payroll and income tax records.

### The Section 179 Deduction Has Been Extended

Section 179 of the Internal Revenue Code allows employers to currently deduct qualified business assets placed in service during the year, up to a specified maximum. So instead of depreciating equipment over several years, businesses can write off the entire cost in one year if they qualify and make this election. The maximum deduction is phased out on a dollar-for-dollar basis for the cost of assets exceeding a threshold amount.

Under an earlier stimulus law, the maximum Section 179 deduction allowed for 2009 was \$250,000, while the phase-out threshold was set at \$800,000. Without an extension, the Section 179 deduction for 2010 had reverted to \$134,000, and the phase-out threshold was \$530,000. Now the new law preserves the higher limits for qualified assets placed in service in tax years beginning in 2010.

**Note:** The *HIRE Act* does not extend the "bonus depreciation" tax break that was also available for business equipment purchases in 2009. However, it does continue to allow businesses to currently deduct the cost of off-the-shelf software placed in

service in 2010.

### Who Pays for the New Tax Breaks?

The tax benefits in the new *HIRE Act* are mainly offset by a package of foreign tax compliance rules. Among other provisions, the law:

- **Imposes 30 percent tax withholding** on payments to foreign banks and trusts that fail to identify U.S. accounts and their owners and assets to the IRS; or foreign corporations that do not supply the name, address, and tax identification number of any U.S. individual with at least 10 percent ownership in the firm.
- **Imposes penalties of up to \$50,000** on U.S. taxpayers who have at least \$50,000 in offshore accounts or assets, but fail to report the accounts on their annual income tax returns.
- **Assesses a 40 percent penalty** on the amount of any understatement attributed to undisclosed foreign assets.
- **Extends the statute of limitations** to six years for "substantial" omissions derived from offshore assets.
- **Requires shareholders** in passive foreign investment companies to file annual returns.
- **Establishes a \$10,000 minimum failure-to-file penalty** for certain foreign-trust related information returns.

To further help pay for the new tax breaks, the new law also delays (until 2021) application of the worldwide interest allocation rules and accelerates certain corporate estimated tax payments.

### What is NOT in the Legislation?

The *HIRE Act* does *not* include a number of tax breaks that you and your clients may be awaiting. We are likely to see additional new legislation this year that covers the extension of several tax breaks that technically expired after 2009, such as the Research Tax Credit, the higher education tuition deduction, the state and local sales tax write-off, and a variety of other business and individual tax breaks.

Similarly, the law did not provide alternative minimum tax (AMT) relief or any revision of the estate and gift tax laws. However, these issues are addressed in other legislative proposals that are currently working their way through Congress, so stay tuned.

The recession has "bottomed out," former Federal Reserve Chairman Alan Greenspan recently stated. But he warned that the recovery will be "slow" and "trudging."



## Ask Five Questions to Help Clients Take Advantage of the Recovery

Although the comments of Greenspan and other economists are cautious, they are good news for struggling business owners who are waiting for a return to prosperity. With the economy showing signs of recovery, now is the time to position your clients' companies to reap the benefits of improved conditions.

Here are five questions business owners and executives can answer to help assess their readiness to take advantage of upcoming opportunities and challenges.

**Question 1: Have the "wants and needs" of customers changed?** Depending on the type of products or services that a company provides, its customers' expectations may have changed during the recession.

For example, a number of restaurants changed their menus to accommodate cash-strapped diners and lunch-time customers who no longer have unlimited expense accounts. In order to attract business, they've added lower-priced options and started running coupons and offering other specials. Once the recovery is in full swing, will diners continue their belt-tighten ways?

Businesses should consider administering a survey to determine if its customers' requirements have been altered by the recession and, consequently, to learn what extent the company needs to change to meet and exceed their future expectations.

Here are some examples of survey questions that can illustrate how customers view a business and identify opportunities:

- Overall, how satisfied are you with our company?
- Would you purchase from us again and recommend us to others?
- On a scale of 1-10, how would you rate our customer service?

- Which of our products and services do you plan to purchase in the near future?
- Are there any products or services we do *not* provide that you would like us to begin offering?
- Would you like to hear about our specials via e-mail or social media Web sites?

### **Question 2: Are employees, as well as the leadership team, ready for the recovery?**

During the recession, company leaders most likely spent considerable time and effort dealing with difficult problems. To make matters worse, many organizations were forced to downsize. As a result, overall morale may be low.

In order to deliver the goods and services that customers want, employees and leadership teams must remain motivated and focused on the right goals. Now is the time to communicate goals and expectations with employees at all levels.

Focus specifically on what the company is doing to thrive in the coming months and years. Frequent, upbeat communication will motivate employees and direct them to focus on the future and not linger on the past.

### **Question 3: Does the company know where to invest newly available capital?**

As sources of credit become available or a company generates more profits, it's important to have a rigorous process in place to quickly determine where to invest capital resources to support long term growth.

Consider developing a list of critical projects -- in order of importance -- which will contribute to the long term profitability of the company. If a formal approval process for

capital projects does not already exist, it's a good time to create such a process.

**Question 4: Does the company's existing technology meet its needs?** During the recession, many companies have deferred or cancelled investment and maintenance of their technology infrastructure. As the economy improves and business picks up, that lack of investment may become apparent, especially if a company's competitors have chosen not to forgo investing in technology.

Coordination is a key factor when planning ahead, especially if a company's IT budget contains only modest increases. This will ensure that technology investments made throughout the company complement each other and support the quick, efficient exchange of data throughout the organization.

### **Question 5: Does the company have a plan to hire, motivate, and retain employees?**

As the economy improves, the demand for talent will increase dramatically. Consider conducting a "talent inventory" that identifies which employees *must* be kept, which employees the managers would *like* to keep, and which employees they would be comfortable losing. This exercise also helps an organization determine where new employees are needed.

Businesses should develop clearly defined requirements regarding the type of employees that they wish to hire and the wages that are needed to attract them. Taking the time now will dramatically reduce the probability of hiring the wrong individuals later.

Thriving during an economic recovery is much easier than surviving during a recession. But no matter what is happening with the economy, it's important to have a plan. The steps above can help guide companies in the coming weeks and months.



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## Estate Planning Uncertainty

As of now, there is no estate or generation-skipping transfer tax for individuals who die this year. Because of changes to the income tax basis rules for property acquired from a decedent in 2010, some heirs could actually face higher combined estate and income tax costs if their loved one dies in 2010 than would have been the case if death had occurred in 2009. Congress could still retroactively reinstate

the estate and generation-skipping transfers taxes to the beginning of this year and restore the favorable prior basis rules that wipe out income tax on pre-death appreciation in asset values. But, so far, this is no clear indication of what lawmakers will do. Apart from tax uncertainty, the continuing inaction could also pose a problem for individuals with wills using formula clauses. These clauses work well when the

estate tax is in force but they may produce unintended consequences when there is no estate tax. Action may need to be taken if it becomes clear that Congress will not be addressing the situation.

*Sometimes when you innovate, you make mistakes. It is best to admit them quickly, and get on with improving your other innovations.*

*Steve Jobs, Apple*

The IRS has issued its annual data book, which provides statistical data on its fiscal year 2009 activities, including how many tax returns it examines (audits). For business returns other than farm returns showing total gross receipts of \$100,000 to \$200,000, 4.2% of returns were audited. For those showing total gross receipts of \$200,000 or more, 3.2% of returns were audited. For returns showing total positive income of \$200,000 to \$1 million, 3.1% of returns showing business activity were audited.

*For further information or questions regarding any topics in this newsletter, email:*

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**Business Ideas at Work**

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