THE EXECUTIVE COMPENSATION GROUP, LLC

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Dear Reader,

After a long process of debate, procedure and Congressional politics, we have Health Care reform. The changes are actually in two pieces of legislation. The Patient Protection and Affordable Care Act was passed by the Senate and the House under normal parliamentary procedures, and the Health Care and Education Reconciliation Act of 2010 was passed under the reconciliation process in the Senate by a simple majority vote and approved by the House. President Obama signed both bills into law last month. The legislation contains sweeping changes to the health care system in the United States, with many tax and other revenue-raising provisions designed to offset portions of its cost. The law includes penalties on individuals who remain uninsured after 2013 under a new health insurance "mandate," penalties on some large employers for failure to provide health coverage to employees after 2013, new excise taxes on "high cost" employer-provided coverage after 2017, and new fees, taxes, and deduction limits applicable to various health-related industries. The Attorney Generals of several states initiated a constitutional challenge to the health insurance mandate, which could create some uncertainty concerning this provision.

There are also targeted tax benefits in the legislation to further the policy objectives of the reform package, including tax credits for certain small employers who purchase health insurance for employees. Some changes included in the legislation, such as a $1,000 increase (to over $13,000) in the adoption tax credit beginning in 2010, are not directly related to health care reform. Overall, the new Act is enormous and cannot be given justice in a short newsletter. In the inside report, we will discuss a few of the more important tax law provisions in some detail. In future letters, we will address some of the other issues, particularly as they are scheduled to take effect.

There is nothing to report with the status of the anticipated federal estate tax reform. The has been some indication that the House of Representatives has begun to discuss the possibility that reform legislation will provide estates (for decedents dying in 2010) the option of choosing either the federal estate tax (as revised in the new legislation) or the modified carryover basis of estate assets (as currently enacted). This would provide some interesting issues to be considered by executors and would increase the compliance costs for settling estates.

Cordially,

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Selected Tax Increase Provisions of The Health Care Reform Laws

Increase in Hospital Insurance Tax for Upper-Income Workers

Under current law, FICA taxes are imposed on an employee's wages at a cumulative rate equal to 15.3 percent. The burden of these taxes is divided equally between the employer and the employee. The employee's share of these taxes is withheld from wages and paid to the government by the employer. The 7.65 percent includes 6.2 percent for the funding of Social Security benefits, and 1.45 percent for the funding of Medicare (the "Hospital Insurance" tax). The Social Security tax is paid on wages only up to the amount of the Social Security wage base ($106,800 for 2010). The Medicare Hospital Insurance tax is paid on all wages regardless of the amount. Self-employed taxpayers are responsible for paying the entire 15.3 percent tax based on their net earnings from self-employment under basically the same rules and limits ("SECA" taxes). An above-the-line federal income tax deduction for one-half of these taxes is available to the self-employed.

For tax years beginning in 2013 and thereafter, the employee portion of the Hospital Insurance tax will be increased by .9 percent for upper income taxpayers on wages in excess of an applicable threshold amount. The threshold amounts are $250,000 for married taxpayers filing jointly, $125,000 for married taxpayers filing separately, and $200,000 for single taxpayers and unmarried heads of households. These threshold amounts are not currently scheduled to be indexed for inflation. For example, a single taxpayer with wages of $300,000 in 2013 will have $100,000 of wages in excess of the applicable threshold of $200,000 subject to an additional tax of $900 ($100,000 x .9 percent). The wages of married taxpayers filing jointly will be combined in determining the amount of wages in excess of their $250,000 threshold amount. For other FICA tax purposes, wages of spouses are not combined.

The additional .9 percent tax does not apply to the employer's share of FICA taxes, but only to the employee's share. However, the employer is required to withhold the additional .9 percent from an employee's wages to the extent that an individual employee's wages are in excess of $200,000. The $200,000 figure applies for purposes of withholding regardless of the employee's tax filing status. The employer will not consider the wages of the employee's spouse in determining the amount of such withholding. Therefore, in many cases the withheld amounts will not correspond exactly to the amount of

additional tax owed by a married couple. For example, if one spouse has wages over $200,000 and the other spouse has wages slightly under that amount; the higher-earning spouse's withholding will not cover all the extra tax. In such cases, taxpayers should file estimated payments to cover additional tax not withheld. Employees will be directly liable for any additional .9 percent tax in excess of the amount withheld by the employer. The direct liability for the payment of other FICA taxes (including the employee's share) generally falls on the employer. The new .9 percent tax involves some complications not encountered with other FICA taxes.

For self-employed taxpayers the threshold amounts are the same as for employees, except that the amounts are based upon self-employment income. These taxpayers should make estimated payments to cover the tax. It is also significant that the .9 percent additional tax will not generate an additional above-the-line deduction for self-employment taxes. That deduction is scheduled to remain the same as under current law. Moreover, if the taxpayer has both wages and net earnings from self-employment, the applicable threshold amount is reduced by the amount of the taxpayer's wages, but not below zero. In other words, there is no separate and additional threshold amount for self-employment income.

Medicare Contribution Tax Will Apply To Unearned Income

The new 3.8 percent Medicare contribution tax on unearned income also applies beginning in 2013. The tax will be imposed on the "net investment income" of upper-income taxpayers. "Net investment income" for purposes of this new tax generally includes interest, dividends, payments from nonqualified annuities, royalties, rents, and capital gains from assets other than those held in a trade or business. Deductions that are properly allocable to such income will reduce net investment income for this purpose.

The 3.8 percent tax rate applies to the *lesser* of the taxpayer's net investment income *or* the amount of the taxpayer's modified adjusted gross income ("MAGI") in excess of the applicable threshold amount. The threshold amounts are the same as those for the additional .9 percent Hospital Insurance tax ($250,000 for married filing jointly, $125,000 for married filing separately, and $200,000 for other individuals). However, this threshold is applied to the taxpayer's MAGI rather than to wages or self-employment income. MAGI for these purposes equals adjusted gross income increased by the amount of certain foreign earned income. The tax is imposed on net investment income to the extent that the taxpayer's MAGI exceeds the applicable threshold. If MAGI exceeds the threshold by more than the amount of net investment income, all the net investment income is subject to the 3.8% tax. This new tax represents the first time that FICA or SECA taxes will apply to unearned income. Many taxpayers should consider this new tax when calculating estimated tax payments for the 2013 tax liability.

The Medicare contribution tax on unearned income is payable *in addition to* the .9 percent increase in the Hospital Insurance tax, if any, payable by the taxpayer. For example, assume a single taxpayer in 2013 has $400,000 in wages, $150,000 in net investment income, and MAGI of $550,000. The taxpayer would be liable for $1,800 in additional tax on his or her wages ($400,000 wages - $200,000 threshold amount, multiplied by .9 percent), and $5,700 on unearned income ($150,000 net investment income multiplied by 3.8 percent) for a total additional tax of $7,500.

Estates and trusts will also be subject to the tax. It will apply to the estate or trust's undistributed net investment income to the extent that such income is taxed in the highest bracket applicable to estates and trusts. In 2010, the highest bracket begins at $11,200 of taxable income, as adjusted for inflation. As a result, accumulation of income in estates and trusts will not be an effective way for individuals to avoid the Medicare contribution. Certain charitable trusts will not be subject to the tax. Also, so-called "simple' trusts will not be directly affected because such trusts distribute income currently. Grantor trusts are taxable to the trust grantor(s), so these will not be directly affected either.

The Medicare contribution tax does not apply to income from a trade or business unless that trade or business is treated as a passive activity under Section 469 of the Internal Revenue Code, or is a certain type of financial instrument or commodity trading business. It also does not apply to distributions from a qualified plan, IRA, or Roth IRA. However, the portion of any distribution from such a plan or account that is subject to federal income tax would increase the taxpayer's MAGI. Hence, the amount of unearned income subject to the tax could be correspondingly increased for many taxpayers who receive distributions from retirement plans, even though such income would not be directly subject to the tax.

Planning techniques will evolve over the next three years to minimize the impact of the new tax on unearned income. Tax-exempt income and other income qualifying for an exclusion may become more beneficial. Roth IRAs will be helpful because nontaxable distributions from these accounts will not be subject to the tax. Nor will nontaxable Roth IRA distributions cause increases to MAGI that might otherwise increase exposure to taxation on investment income. Some taxpayers may wish to convert traditional IRA accounts to Roth IRAs before 2013 to avoid increasing their MAGI above the threshold amount after 2012 because of taxable plan distributions.

The current low income tax rates on long-term capital gains and dividends are scheduled to expire at the end of 2010. Higher capital gain and dividend rates after 2010 combined with the 3.8 percent tax beginning in 2013 could make the overall tax rate on investment income significantly higher for upper-income taxpayers. For example, suppose the maximum individual rate on long-term capital gains is increased from 15 percent to 20 percent beginning in 2011. When the 3.8 percent tax begins in 2013, the federal income

tax on such capital gains could be as much as 23.8 percent, which represents a 59 percent increase over the current maximum 15 percent rate. Some taxpayers may choose to realize capital gains before higher rates go into effect. However, the prospective impact of any tax on financial markets is never easy to predict.

Increase in 7.5 Percent "Floor" for Individual Medical Expense Deductions

Also beginning in 2013, an individual taxpayer's qualifying medical expenses will generally be deductible on Schedule A of Form 1040 only to the extent that the total of such deductions exceeds 10 (up from 7.5) percent of the taxpayer's adjusted gross income ("AGI"). For the years 2013 through 2016, the floor will remain at 7.5 percent for taxpayers who have reached the age of 65 before the end of the tax year. For married couples, the increase in the deduction floor to 10 percent of AGI won't apply for those years if *either* spouse is 65 years of age before the end of the tax year. Interestingly, it appears that this rule will apply to *both* spouses even if they file separate tax returns. After 2016, however, all taxpayers will be subject to a 10 percent floor. Note that the 10 percent floor already applied to taxpayers for determining their potential alternative minimum tax ("AMT") liability.

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