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NEW RULES AND A GLIMPSE OF THE FUTURE
(The Health Care Act and the HIRE Act)

Changes to the tax laws will significantly affect individuals and business in 2010 and in the years to come, but one thing is clear – tax rates are going up. This letter summarizes some of the key provisions of recently enacted legislation and other changes taking effect after the end of this year.

Congress recently enacted new legislation with significant tax provisions. The Patient Protection and Affordable Health Care Act as modified by the Health Care Education Reconciliation Act (the "Health Care Act") provides tax incentives for health insurance coverage and increases the tax rates on high income earners. The Hiring Incentives to Restore Employment Act (the "HIRE Act") provides tax incentives for businesses to hire and retain new workers. Illinois recently enacted a similar tax credit for hiring and retaining new workers as well.

The Health Care Act

Small Business Tax Credit: The Health Care Act seeks to extend health insurance coverage to more Americans through a system of tax incentives and penalties for individuals and business. The most significant change that goes into effect this year is that small businesses may qualify for a tax credit for up to 35 percent of their contribution to their employees' health insurance premiums. Employers with fewer than 25 "full time equivalent" employees and average employee wages of under $50,000 are eligible to receive the tax credit. The number of "full time equivalent" employees is determined based upon the number of hours worked, so an employer with 25 or more employees may still qualify if some of the employees work part-time. To qualify for credit, eligible employers must pay at least 50% of the health insurance premiums for their employees. The credit phases out as firm size and average wages increase. In addition, self-employed individuals, sole proprietors, partners, 2% shareholders of an S corporation and 5% owners are not counted as "employees" for purposes of the credit, and there is a special rule that denies the credit for premium payments made for family members of sole proprietorships.

> **Tip**: If your business has 25 or more employees, you may want to review the number of hours worked by each employee to see if your business can still qualify for a tax credit.

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Individual Health Care Savings Accounts and Expenses: Changes have been made to certain types of tax-benefited health savings plans and to the deductibility of medical expenses. Starting next year, funds from tax-benefited savings accounts for medical expenses may no longer be used to pay for over-the-counter medications unless they are prescribed by a doctor. In addition, the penalty for non-qualified distributions increases to 20% from 10%. Beginning in 2013, contributions to flexible spending accounts will be capped at $2,500, and the floor for itemized medical deductions for individuals under 65 will increase to 10% of adjusted gross income from the current 7.5% (the 7.5% floor remains in effect for those 65 and over until 2017).

Tax Increase on High Incomes: Tax rate increases go into effect in 2013 for individuals with income over $200,000 and couples with joint income over $250,000. First, a Medicare surtax of 0.9% applies to earned income on the excess over these dollar thresholds, increasing the total Medicare tax on that excess amount to 2.35%. The surtax will be collected by employers, but there is no increase in the employer share of the Medicare tax.

Second, an additional tax of 3.8% will apply to individuals with income from all sources over the $200,000/$250,000 thresholds. This tax is applied to the lesser of (i) modified adjusted gross income ("MAGI") over the threshold amount or (ii) net investment income. Net investment income includes dividends, royalties, rents, passive business income, and capital gains from passive activity, but does not include distributions from tax-benefited retirement accounts.

<u>Example</u>: In 2013, an individual has net investment income of $40,000 and $220,000 of MAGI (which includes the net investment income). The tax will apply to lesser of (i) $40,000 of net investment income or (ii) $20,000 of MAGI over the $200,000 threshold. The tax will be equal to 3.8% times $20,000 = $760. The 0.9% surtax does not apply because earned income is less than $200,000.

The $200,000/$250,000 thresholds for both of these tax increases are not indexed for inflation.

> **Tip:** Since the 3.8% tax will not apply to distributions from tax-benefited retirement accounts, you may want to increase your contributions to such accounts and, if your company does not have a qualified retirement plan, you may want to review again whether establishing such a plan makes sense. Also the tax does not apply to interest from tax exempt bonds.

Future Health Insurance Changes: Starting in 2011, fully-insured group health insurance plans will be prohibited from discriminating in favor of "highly compensated individuals" as to eligibility to participate in the plan and in providing benefits under the plan, although plans in effect as of March 23, 2010 are exempted. The IRS is expected to issue regulations describing what changes in an exempted plan may cause it to lose its exempt status. Many of the most significant provisions of the Health Care Act do not go into effect until after 2013, including (i) the "individual mandate" that requires most individuals to have health insurance coverage or pay a penalty, (ii) the "premium assistance tax credit" for low and middle income families (family income below four times the national poverty level) who are not eligible for Medicaid, employer-sponsored coverage or other acceptable coverage to purchase health insurance through new insurance exchanges, (iii) the requirement for employers with at least 50 full time employees to provide health insurance or pay a penalty, (iv) the requirement for employers to offer "free choice vouchers" to low and middle income (four times poverty level) employees to purchase health insurance from new health exchanges in certain cases. Starting in 2018, a tax on "Cadillac" health plans (those with premiums of more than $10,200 for single coverage and $27,500 for family coverage) is imposed on insurance companies and plan administrators.

Planning for 2011 Tax Rate Increases:

In addition to the changes discussed above, income tax rates are expected to increase at the end of this year. The Obama Administration has indicated that it plans to let the tax cuts enacted during the Bush Administration expire on schedule on December 31, 2010. This means that the highest marginal income tax rate will return to 39.6% from the current 35% and the tax rate on long term capital gains will increase from 15% to 20%. In addition, dividends will once again be treated as ordinary income subject to marginal income tax rates rather than a special 15% rate. State and local income taxes for business and individuals in Illinois (as well as other states) also are likely to rise given the current severe budgetary constraints.

> **Tip:** In certain situations it may be more tax efficient to accelerate transactions to recognize income in 2010 or delay transactions to defer deductions until 2011 and beyond.

The HIRE Act

Hiring Incentives: The centerpiece of the HIRE Act is tax breaks for private sector businesses to boost hiring of unemployed workers in 2010. First, a business that hires a previously unemployed individual will be relieved of liability for the 6.2% Social Security tax (but not the Medicare tax). For the employer to qualify for this benefit, the new employee (i) must be hired between February 1, 2010 and January 1, 2011, (ii) must certify that he or she was not employed for more than 40 hours during the 60 day period ending on the date of hiring, and (iii) cannot be replacing a current employee unless the current employee quit voluntarily or was terminated for cause. The new employee may be hired either part-time or full time. Second, if the hiring of a new employee qualified the employer for the Social Security tax benefit, then the employer is eligible for a tax credit if the employee is retained for 52 consecutive weeks. The credit is equal to the lesser of $1,000 or 6.2% of the wages paid to the employee during the 52 week period (i.e., a $1,000 cap will apply if wages during the period exceed approximately $16,130).

In addition to the tax benefits for hiring and keeping new workers, the HIRE Act includes an extension of enhanced expensing of qualified business property purchases through December 31, 2010. The maximum deduction remains at $250,000 with a phase-out limit for property purchased during the year of $800,000.

> **Tip:** The tax credit for hiring new employees is already in effect and is taken through reduced payroll withholding. Employers should consider asking employees hired after February 1 if they meet the requirements to claim the credit. If your business has a qualifying new hire, then you may need to adjust your quarterly payroll tax withholding payments.

Increased Foreign Reporting: If you hold investments in foreign assets, then your tax return is going to get thicker and you may be required to provide more information to the financial institutions holding your foreign accounts because of new reporting requirements in the HIRE Act. First, withholding will be required from payments made by U.S. persons to a foreign account of a U.S. holder starting in 2013, unless the U.S. account holder waives any rights under foreign bank secrecy laws and the foreign financial institution reports to the IRS the name, address and tax identification number of the U.S. account holder. Second, individuals holding interests in certain foreign assets with an aggregate value of over $50,000 will have to attach to their tax returns an additional disclosure statement with the account number and name of the foreign financial institution maintaining each account as well as the maximum value of the asset during the tax year. Individuals who fail to make the required disclosures may be subject to penalties from $10,000 to $50,000 and a 40% penalty will apply to the portion of any tax underpayment attributable to an undisclosed foreign asset. In addition, additional reporting will be required with respect to foreign trusts and to investments in passive foreign investment companies.

The Illinois Small Business Job Creation Tax Act

Hiring Incentives: Businesses operating in Illinois may qualify for a new tax credit of up to $2,500 for each new full-time employee hired between July 1, 2010 and June 30, 2011. To qualify for the credit (i) the employer must have no more than 50 full-time employees (both within and outside Illinois) as of July 1, 2010, (ii) the employee must be hired to work at least 35 hours a week at a wage of at least $13.75 per hour (approximately $25,000 per year), (iii) the employee cannot have previously worked for the employer, (iv) the employee must remain employed for 12 months and (iv) the employer must have a net increase in its number of overall full-time employees during the 12 month period. There is a three part process to claim the credit. First, the employer must apply for a certificate from the Illinois Department of Commerce and Economic Opportunity (the "IDCEO") when the employee is hired. Second, the employer must request a credit award from the IDCEO after the 12 month minimum employment period is completed. Finally, the employer claims the credit on its Illinois withholding tax returns filed with the Illinois Department of Revenue. The available credits are limited to $50,000,000 and are awarded on a first come-first served basis based upon the date of the first filing with the IDCEO. Also, an employer may lose its priority for the credit if it does not request the credit from IDCEO within 90 days of the completion of the 12 month minimum employment period. The credit is not refundable, but may be carried forward for up to five years.

> **Tip:** In order to have the best chance to get the maximum number of credits for which your business may qualify be sure to file with the IDCEO as soon as possible after a new employee is hired and remember to claim the credit within the 90 day window after the 12 month minimum employment period for each new employee.

> **Tip:** Illinois employers hiring new full-time employees between July 1, 2010 and January 1, 2011 may qualify for both the federal Social Security tax credits under the HIRE Act and the new Illinois tax credit.

How We Can Help:

The recent changes in the federal and Illinois income tax laws present opportunities for business to reap tax benefits from hiring new employees and providing health insurance to their employees, but they also bring tax increases for high income individuals in the coming years. For both businesses and individuals, the application of these provisions may be complex and the reporting burdens may be significant. Please contact any of our attorneys who specialize in income tax planning if you would like further information about the changes in the federal tax rules that may affect your personal income taxes or those of your business.

The information described herein is of a general nature, based on information currently available, and should not be relied upon to make planning, purchase, sale, or exchange decisions without seeking personal professional advice.

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