

Contact AUC at:
615.224.1291

Health Care Reform is Law—New Taxes Coming

On March 30, 2010, the Health Care and Education Reconciliation Act of 2010 became law. In this legislation are numerous changes to the tax laws including provisions that require certain employers to provide health insurance to employees. The Act creates new taxes on individuals and owners of small businesses. Here is a brief summary.

Medicare Tax on Net Investment Income

There is a new 3.8% Medicare surtax on the lesser of (1) net investment income, or (2) the excess of modified adjusted income over a threshold amount.

The threshold amount is \$250,000 for married couples filing jointly, \$125,000 for married couples filing separately, \$200,000 for single taxpayers, and approximately \$12,000 for trusts and estates.

Net investment income includes interest received, dividends, capital gains, rents, royalties and passive activity income. Net investment income does **not** include active trade or business income, deferred compensation, distributions from IRAs or retirement plans, municipal bond income, distributions from life insurance contracts or non-qualified deferred annuities, any income reported for self-employment tax, or gain on the sale of an active interest in a partnership or S corporation.

The new surtax becomes effective January 1, 2013.

Here's an example of how it works. Say a married couple, filing jointly, has salaries

that total \$400,000 for the year plus \$100,000 of net investment income. Under the new law, they will pay an additional surtax of 3.8% on \$100,000 or \$3,800. This is in addition to any ordinary income tax or capital gains tax they would otherwise owe.

High earners will want to maximize investment in deferred compensation, company retirement plans, IRAs, life insurance, and non-qualified deferred annuities as distributions from those plans are not subject to the surtax.

Small business owners may want to consider doing business as a partnership or S corporation rather than a C corporation. They may also want to avoid taking distributions out of a C corporation as dividends.

Increase in Medicare Portion of FICA

Currently, the FICA tax for Medicare is 1.45% for both employer and employee. Note that unlike the portion going for Social Security, the Medicare tax is **not** capped at \$106,800. Beginning January 1, 2013, the tax will increase by .9 % for both employer and employee to a total of 2.35% for each, 4.7% together. For someone earning a salary of \$500,000 per year this would mean an increase of \$4,500 per year in personal FICA taxes, \$9,000 in total employee and employer contributions.

Small business owners may want to consider operating as an S corporation, and passing net profits through as an S corporation dividend, rather than a salary to the extent feasible.



Lawrence J. Owens
JD, CLU, ChFC, MBA, FLMI

Steve Fichtenbaum
JD, LLM, CLU, CFP

Roy Morris
CLU, CFP

Michael Sharry
JD

Linas Sudzius
JD, CLU, ChFC

Gaylord Gardner
JD

Gweyn Colaberdino
JD

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Excise Tax on “Cadillac” Health Care Plans

The law adds a new Code section 4980I that will impose a 40% tax on “excess benefits” under an employer sponsored health care plan. Excess benefits are the cost of a health plan that exceeds \$10,200 per year for individual plans and \$27,500 per year for all other plans. This new tax goes into effect January 1, 2018.

Small business owners with Cadillac health care plans will want to consider other alternatives prior to 2018.

Excise Tax on Uninsured Individuals

The Act creates a new Code Section 5000A which imposes an excise tax on US citizens who fail to maintain minimum health care coverage.

Individuals who fail to maintain minimum essential coverage will be subject to a penalty equal to the greater of:

- 2.5% of the amount by which the taxpayer's household income for the tax year exceeds the threshold amount of income required for income tax return filing under section 6012(a)(1); or
- \$695 per uninsured adult in the household.

The penalty will be phased in from 2014 to 2016. For 2014, the penalty will be the greater of 1% of household income over the filing threshold or \$95; for 2015, it will be the greater of 2% of household income over the filing threshold or \$325; and for 2016 it will be the full 2.5% or \$695.

Medical Care Itemized Deduction Threshold Increased

The threshold for the itemized deduction for unreimbursed medical expenses is increased from 7.5% of AGI to 10% of AGI for regular income tax purposes. This is effective for tax years beginning after Dec. 31, 2012, except that in the years 2013 to 2016, if either the taxpayer or the taxpayer's spouse has turned 65 before the end of the tax year, the increased threshold does not apply and the threshold remains at 7.5% of AGI.



Private Letter Ruling Allows Deductible Loss on Surrender of Business Owned Life Insurance

Since the 1930s, IRS has taken the position there can be no income tax deduction taken when a life insurance contract is sold or surrendered at a loss. A recent Private Letter Ruling (PLR), 200945032, did, however, allow a deduction when a Business Owned Life Insurance (BOLI) policy was surrendered at a loss.

Prior Rulings

In the 1930s, the Federal courts decided two cases that established the precedent that there is no deduction for a loss on sale or surrender of a life policy. The two cases were *Century Wood Preserving Co. v. Commissioner*, 69 F.2d 967 (3rd Cir., 1934) and *London Shoe Co. v. Commissioner*, 80 F.2d 230 (2nd Cir., 1935).

In *Century Wood Preserving Co.* the employer owned participating whole life policies on the lives of corporate officers. When several of the officers retired, they purchased the policies on each of their respective lives for the cash surrender value. The total premiums paid for the policies were \$98,242, but dividends of \$14,089.91 were received, for a net cost basis of \$84,152.09. The cash surrender value of the policies received upon the sale was \$57,646.57. The company claimed a loss deduction of \$25,962. The IRS denied the deduction and was upheld by the Federal Court.

The court stated any loss must be determined based on the cost basis of the property, but goes on to say that the cost basis of insurance is not the total premiums paid because some portion of the premium goes towards the purchase of life insurance protection (the COI). Only the excess over the amount required to purchase the protection goes into a reserve and becomes the basis of the policy. The court then assumes the cost basis of the policy is equal to cash surrender value.

In *London Shoe Co.* the company likewise owned a whole life policy. Over seven years, premiums of \$63,679 were paid and dividends of \$13,117 were received for a net cost of \$50,562. In 1931, the policy was surrendered and cash surrender value of \$24,600 was received. The company claimed a deduction loss of \$25,962. IRS denied the deduction and was upheld by the Federal Court. The reasoning was consistent with that in the *Century Wood* case.

Private Letter Ruling 200945032

In PLR 200945032, a bank owned several policies (BOLI) for purposes of offsetting future employee benefits. The policies were variable universal life (VUL) type policies. Apparently, the VUL policies had not performed well and the cash surrender value was far less than the total premiums paid. The bank proposed to surrender the policies and sought a ruling that an income tax deduction may be taken for the amount by which total premiums exceeds the cash surrender value.

In a somewhat surprising result, IRS held that in this particular case, a loss deduction may be taken, but only after the basis in the policies is adjusted for cost of insurance:

“The amount of the loss deduction for each of the ... policies shall be computed by subtracting the applicable tax basis of each policy from the surrender proceeds of each policy ... In the present situation, we conclude that the tax basis of the policies ... shall equal the sum of the premium payments ... plus the mortality credits, less the cost of insurance ... less the mortality and expense deduction (net of mortality experience credits)”

It's probably safe to assume the IRS is attempting to follow the reasoning set out in recent Revenue Ruling 2009-13, Situation 2, in which guidance is given in valuing a life insurance policy upon its sale. In that example, the taxpayer had paid total premiums of \$64,000 and proposed to sell the policy for \$80,000. IRS stated that in determining the gain, the premiums paid would have to be reduced by the cost of insurance for the policy (\$10,000). Thus, the adjusted basis in the policy would be \$64,000 minus \$10,000, or \$54,000 and the taxable gain would be \$80,000 minus \$54,000, or \$26,000.

Even though PLR 200945032 involves surrender of the policy rather than sale - for purposes of determining loss - the logic of Rev. Rul. 2009-13 is followed and the adjusted basis in the policy is reached by subtracting the COI from the premiums paid.



370 Mallory Station Road
Suite 512
Franklin, TN 37067

Private Letter Ruling Allows Deductible Loss on Surrender of Business Owned Life Insurance(Continued)

Conclusion

While this PLR is good news for BOLI and businesses thinking of selling or surrendering policies at a loss, there's no guarantee that the same treatment will be accorded personally owned policies. The rules for taking tax deductions losses for businesses and individuals may be totally different.

In general, in order for an individual to take a deduction for a loss, it must be shown that the loss was in connection with a transaction entered into for profit. Life insurance premiums paid for personal life insurance have traditionally been treated as a personal expenditure rather than entered into for profit. We shall have to await further guidance on this point.

A second pending issue is that more clarification is needed on how COI is determined. PLR 200945032 does not explain how the COI is calculated. The IRS apparently accepted the number submitted by the taxpayer but we don't know whether it was arrived at

from company entries for that specific policy, from a generic table, or otherwise. Rev. Ruling 2009-13 was similarly vague in describing precisely how COI is calculated.

Some commentators are concerned by what might be seen as inconsistent treatment by IRS of COI adjustments depending upon the circumstances. In Rev. Ruling 2009-32, the IRS ruled that the taxpayer's basis in the contract does not have to be adjusted for COI when determining gain on surrender of the contract. PLR 200945032 now says the basis does have to be adjusted when determining loss on surrender. Other commentators question the IRS position that COI does not have to be taken into account on surrender of a contract for gain, but does have be factored in for determining gain on sale of the same contract, and feel the IRS reasoning is faulty. We look forward to further developments.