

## 2011 HIGH INCOME NEWSLETTER

### PRESIDENT OBAMA RECOMMENDS TAX INCREASES FOR HIGH-INCOME TAXPAYERS

Last month, President Obama addressed Congress and explained the concept of the Buffett Rule, "People making more than \$1 million a year should not pay a smaller share of their income in taxes than middle-class families pay. To assist the Committee in its work, I also included specific tax loophole closers and measures to broaden the tax base. Together with the expiration of the high-income tax cuts from 2001 and 2003, these measures would be more than enough to reach this \$1.5 trillion target... They include cutting tax preferences for high-income households."

The one big stumbling block to this strategy is that the President doesn't actually write the bills that ultimately become the laws. Instead, the President only signs or vetoes bills passed by Congress. If you grew up in the 70's, you probably remember the Schoolhouse Rock video "I'm Just a Bill". Please take a few minutes to watch this YouTube video for either nostalgic reasons or as a refresher course in basic Civics (<http://www.youtube.com/watch?v=mEJL2Uuv-oQ>).

Let's take a look at the recommendations made by the Obama Administration. Included in their report, the current Administration outlines their Principles of Tax Reform as follows:

- 1. Lower tax rates.** *The tax system should be simplified and work for all Americans with lower individual and corporate tax rates and fewer brackets.*
- 2. Cut Inefficient and Unfair Tax Breaks.** *Cut tax breaks that are inefficient, unfair, or both so that the American people and businesses spend less time and less money each year filing taxes and cannot avoid their responsibility by gaming the system.*
- 3. Cut the deficit.** *Cut the deficit by \$1.5 trillion over the next decade through tax reform, including the expiration of tax cuts for single taxpayers making over \$200,000 and married couples making over \$250,000.*
- 4. Increase job creation and growth in the United States.** *Make America stronger at home and more*

*competitive globally by increasing the incentive to work and invest in the United States.*

**5. Observe the Buffett Rule.** *No household making over \$1 million annually should pay a smaller share of its income in taxes than middle-class families pay. As Warren Buffett has pointed out, his effective tax rate is lower than his secretary's. This rule will be achieved as part of an overall reform that increases the progressivity of the tax code.*

To be perfectly honest, there's nothing too earth shattering in these Principles of Tax Reform. Tax simplification and the equitableness of the Tax Code have been two issues that Congress and each President have grappled with ever since the federal income taxes were enacted on a permanent basis back in 1913.

#### The Specifics:

President Obama's address last month included some specific changes he would like to see Congress make to the Tax Code, including:

#### **Allow the 2001 and 2003 high-income tax cuts to expire**

Simply stated, by Congress not doing anything, the tax rates are set to increase in 2013 for ordinary income, capital gains, and qualified dividends. The President says that he only wants to see the tax rates increase for households with income in excess of \$250k, however.

A summary of tax breaks enacted in 2001 are available in our July 2001 Newsletter (<http://www.mdtaxes.com/news0711.html>). You can read about the 2003 tax law changes in our June 2003 Newsletter (<http://www.mdtaxes.com/news0603.html>).

#### **Reduce the value of a deduction**

President Obama's second suggestion is to reduce the value of itemized deductions and other tax breaks to 28 percent for families with incomes over \$250,000 and single individuals with income over \$200,000.

Generally, tax deductions reduce a person's tax liability based on that person's tax bracket. Someone in the top bracket paying \$10k of mortgage interest saves \$3.5k in federal income taxes.

Under this proposal, even if a taxpayer is in the 33% or 35% tax bracket, the tax break for their deductions will be capped at 28%. A person in the top bracket, therefore, will

pay an extra \$700 in federal income taxes for each \$10,000 of allowable deductions claimed.

According to the President's proposal, "This limit would apply to: all itemized deductions; foreign excluded income; tax-exempt interest; employer sponsored health insurance; and selected above-the-line deductions."

### **A Green Tinted Lining**

As part of his address to Congress, President Obama proposed that Congress pass The American Jobs Act. The President would like to see this Act include a provision that would cut in half the Social Security taxes currently being withheld from each worker's wages, as follows:

*Cut the employee payroll tax in half next year for 160 million workers. Almost every working American pays payroll taxes, and middle-class Americans face a higher burden because more of their income comes from wages and salaries. The President's plan will cut payroll taxes in half for employees next year. Rather than having 6.2 percent of their wages deducted in payroll taxes, workers will only pay 3.1 percent next year. This builds on the 2 percentage point payroll tax reduction that the President secured for workers in 2011—providing 160 million Americans the certainty of ongoing tax relief and increasing the amount of that relief by more than 50 percent.*

With the Social Security Max currently at \$106,800, this provision would save high-income taxpayers as much as \$3,311 each year. For people in the top tax bracket, this break in Social Security taxes will offset the President's proposed tax increase on the first \$47,300 of deductions claimed.

### **Wait and See**

President Obama's proposal is just that, a proposal. All we know for certain is that the tax rules in place right now will continue through 2012. With the next Presidential election set for November 2012, who knows when Congress will be able to pass a bill addressing the post-2012 tax rules, and what changes to the tax laws that bill will contain.

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## **STARTUPS AND SMALL BUSINESS CAPITAL GAINS EXCLUSION EXTENDED THROUGH 12/31/11**

The "Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010," includes an extension of the 100% exclusion from income of the gain from the sale of qualifying small business stock acquired as discussed below.

The above Act contains a number of provisions aimed at encouraging investment in small businesses. These provisions include an amendment to Section 1202 of the Internal Revenue Code of 1986, as amended (the "Code"), temporarily permitting the exclusion of 100 percent of the gain from the sale of certain "qualified small business stock" acquired after September 27, 2010 and before January 1, 2011 that is held for more than five years by a non-corporate taxpayer. The new rule extends the deadline for purchasing "qualified small business stock" by one year.

Qualifying small business stock must be acquired from a C corporation whose gross assets do not exceed \$50 million. The amount of gain eligible for the exclusion is limited to the greater of ten times the taxpayer's basis in the stock or \$10 million of gain from stock in that corporation.

More information about this potentially lucrative tax break is available on page 65 of IRS Publication 550, Investment Income and Expenses (<http://www.irs.gov/pub/irs-pdf/p550.pdf>).

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## **TRAVELING ABROAD TO EARN SOME EXTRA INCOME? THE IRS HAS A FORM FOR THAT**

Recently, we've had a handful of clients send us e-mails that include this request from foreign businesses that they will be working with:

*As we have previously informed you, you will be receiving honorarium for your lectures. To pay you the full amount, we will be needing you to give us certificates of residence the IRS will issue. This document will be necessary to avoid double taxation. It may take more than a month to obtain this document, so we would like you to make your application as soon as possible.*

After doing some research, we determined that the taxpayer is being asked to obtain a Form 6166, Certificate of Residency, from the IRS. In order to get the IRS to prepare a Form 6166, you need to complete and submit a Form 8802.

Here is information provided by the IRS about the Certificate of Residency:

### **Form 6166 - Certification of U.S. Tax Residency**

#### **Information on Completing the Form 8802, Application for United States Residency Certification**

*Many U.S. treaty partners require the IRS to certify that the person claiming treaty benefits is a resident of the United States for federal tax purposes. The IRS provides this residency certification on Form 6166, a letter of U.S. residency certification.*

*The Internal Revenue Service (IRS) procedure for requesting a certificate of residency (Form 6166) from the Philadelphia Accounts Management Center is the submission of Form 8802, Application for United States Residency Certification (<http://www.irs.gov/pub/irs-pdf/f8802.pdf>). Use of the Form 8802 is mandatory.*

*Form 6166 is a letter printed on U.S. Department of Treasury stationery certifying that the individuals or entities listed are residents of the United States for purposes of the income tax laws of the United States. You may use this form to claim income tax treaty benefits and certain other tax benefits in foreign countries. Please refer to the instructions for Form 8802.*

*Some additional information will also be required in order to obtain certification under the new procedures. This information is generally set forth in the Instructions to Form 8802 (<http://www.irs.gov/pub/irs-pdf/i8802.pdf>). As the IRS gains experience with processing applications using Form 8802, it may update the Form and Instructions accordingly.*

#### **User Fee**

*A user fee will be charged to process all Forms 8802 received with a postmark date on or after November 1, 2006.*

Since it appears that many foreign business are now looking for you to provide them with a Form 6166, and it takes at least a month to obtain this form, make sure to submit the Form 8802 with the IRS as soon as you know that you'll be heading abroad to earn some income. If you need help completing this form, please let us know.

There are a few different ways for people to save taxes based on the medical expenses they incur. Sadly, the Patient Protection and Affordable Care Act, signed into law on March 23, 2010, reduces many of these tax breaks.

#### **2011 Changes:**

The first changes took effect on January 1, 2011. As of New Year's Day, you can no longer use money set aside in your flexible spending account to pay for over the counter medications. According to the IRS:

*Under the new standard, the cost of an over-the-counter medicine or drug cannot be reimbursed from the account unless a prescription is obtained. The change does not affect insulin, even if purchased without a prescription, or other health care expenses such as medical devices, eye glasses, contact lenses, co-pays and deductibles. The new standard applies only to purchases made on or after Jan. 1, 2011, so claims for medicines or drugs purchased without a prescription in 2010 can still be reimbursed in 2011, if allowed by the employer's plan.*

A second revenue raiser deals with the penalty for withdrawing money from a Health Savings Account that is not used to pay for your family's health care costs. Prior to this year, this penalty was equal of 10% of each dollar withdrawn. Beginning in 2011, the penalty doubles to 20% for non-healthcare withdrawals from an HSA.

#### **2013 Changes:**

The next wave of tax increases takes effect in 2013. For starters, the annual max you can set aside through your employer sponsored Flexible Spending Account for medical expenses is cut in half to \$2,500. Remember, with an FSA, you pay for medical expenses with pre-tax dollars. Married couples where both spouses work, therefore, stand to lose out on up to \$5k of pre-tax medical spending each year.

The second change impacts the medical deduction you can claim as an itemized deduction on your tax return. Starting in 2013, you can only deduct medical expenses paid on behalf of you and your family to the extent the amount spent during the year exceeds 10% of your Adjusted Gross Income. Under the current rules, the threshold is 7.5% of AGI. For every \$100k of income, therefore, expect to lose out on as much as \$2.5k of your medical deduction. Please note that this increase will not affect taxpayers over the age of 65 until 2017.

There is some good news, however. The rules do not impact the medical expenses allowed when calculating the dreaded AMT. Since the current threshold for deducting medical expenses under the AMT is already

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10% of AGI, many people who are hit by this tax every year might not see any tax increase due to this change.

#### **Thereafter:**

Like the universal health insurance rules we have here in Massachusetts, the Patient Protection Act adds a penalty for individuals who don't have health insurance that meets a "minimum essential coverage" threshold. This new non-coverage penalty starts at \$95 per person in 2014, jumps to \$325 per person in 2015, and then jumps again to \$695 per person the next year. After 2016, this penalty is indexed for inflation. Expect to report and remit this penalty as part of your federal income tax return.

There will also be an excise tax on "High Cost Employer-Sponsored Health Coverage" starting in 2018. This excise tax will be equal to 40% of the amount that the annual health insurance premium paid exceeds \$10,200 for single individuals and \$27,500 from families. The Act did include a higher threshold for the first three years for taxpayers who live in the 17 states with the highest health insurance costs.

#### **HSAs Look Even Better:**

Besides increasing the penalty for money withdrawn from a Health Savings Account (HSA) not used for your family's health care expenses, the Act did not affect HSAs. As we wrote in our Feb. 2009 Newsletter (<http://www.mdtaxes.com/news0209.html>), HSAs are a great tool to help you minimize your healthcare costs and save taxes.

Here are four tax breaks available to you if you contribute to an HSA:

- Money contributed into an HSA is tax-deductible. Either you contribute into an HSA on your own, or your employer contributes on your behalf.
- Money invested within the HSA is your money and grows tax-deferred. Unlike Flexible Spending Accounts (FSA) offered to you as part of your employee benefit package where you set aside a set amount of money to pay for your family's healthcare costs with pre-tax dollars, there is no "use it or lose it" pitfall with HSAs.
- Money can be withdrawn tax-free from your HSA at any time to pay for your family's healthcare expenses.
- Any money remaining in your HSA upon your reaching the age of 65 is available to subsidize your retirement.

For 2011, you qualify to set up an HSA if your health insurance plan has a deductible of at least \$1,200 for an individual plan or \$2,400 for a family plan. Single taxpayers can then contribute up to \$3,050 (in 2010) into an HSA while Married Couples can contribute up to \$6,150 (in 2010) annually. Please note that the amount you can contribute into an HSA exceeds your annual deductible, which is one reason that HSAs are so attractive.

To find out more about HSAs, check out IRS Publication 969, Health Savings Accounts and Other Tax-Favored Health Plans (<http://www.irs.gov/pub/irs-pdf/p969.pdf>). You can also read through the instructions to the Form 8889 (<http://www.irs.gov/pub/irs-pdf/i8889.pdf>), Health Savings Accounts.

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## **COLLEGE FINANCIAL PLANNING UPDATE**

Susan Schwartz, CFP is pleased to announce that she has partnered with Strategies for College, Inc. to offer comprehensive college planning services.

Strategies for College is a fee-based corporation that has assisted families for over 20 years with a unique integrated approach to college admissions and cost management. This approach is focused on combining student competitive position with family financial objectives to develop strategies that result in affordable, quality college placements.

For more information and to sign up for their "opt-in" newsletter, visit [www.strategiesforcollege.com](http://www.strategiesforcollege.com).

To schedule a meeting with Susan to discuss your family's college financial planning needs, please email her at [susan@schwartzaccountants.com](mailto:susan@schwartzaccountants.com) or call our office at 800.471.0045.

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## **DID YOU KNOW:**

- The **maximum annual contribution** into a **401(k)** or a **403(b)** plan is \$16,500 in 2011. And if you'll be 50 or older by December 31st, you can contribute an extra \$5,500 that year.
- The **maximum annual contribution** to your **IRA** is \$5,000 for 2011. And if you turn 50 by December 31st, you can contribute an extra \$1,000 that year. You have until April 15, 2012 to make your 2011 IRA contributions.