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Tax Letter

Unintended Consequences

The Healthcare Reform Act (H.R. 3590), Public Law 111-148, consisted of a number of unintended consequences which are unrelated to healthcare at all. In this letter, we will discuss two of them which, in our opinion, having significant impact upon small businesses and/or individual taxpayers.

(A) 1099 Changes – effective 2012

Currently, in general, every person or business who pay for (i) non employee services, (ii) rent, (iii) royalty and (iv) others are required to annually file with the IRS a Form 1099 for each and every payee if the annual aggregate payment to that payee would be $600 or more. The form should document the total amount paid to each payee and the associated purposes of payment. Fortunately, there is a Corporation payee exemption.

Starting in 2012, the Healthcare Reform Act will require all businesses, small and/or independent businesses, to file the annual Form 1099 for purchases of goods and supplies as well. This means, regardless of the size of the payee organization, every business (large or small) shall be required to prepare and file a Form 1099 annually to the IRS if they paid anyone equal to an annual aggregate of $600 or more for services and/or for purchases of goods, materials and supplies. Furthermore, no payee can be exempted, including very large Corporations. Failure to do so, the business may be subject to substantial penalties.

The following examples can serve to explain the impact and significance of the new law upon small businesses and individual taxpayers:

Example 1 - A small restaurant purchases their supplies and food items from large suppliers such as Costco numerous times in a given year, and almost on a daily basis from local independent suppliers for fresh produces and seafood. Effective 2012, this small restaurant must document the total aggregate annual purchases from each supplier. If the aggregate amount is $600 or more, A Form 1099 must be prepared annually for each and every supplier (including Costco) whose annual aggregate amount is $600 or more.

Example 2 – A small professional service provider, such as medical, legal, accounting, engineering and etc, purchase their office supplies, stationeries and material from many large or small suppliers such as Office Depot, Office Max, any neighborhood stores, etc. These purchases could be numerous depending upon the business itself. Effective 2012, this small professional service provider must document the total aggregate purchases from all suppliers. This small service provider must prepare and file a Form 1099 with the IRS, annually, for each and every supplier (including Office Depot) when the annual aggregate amount is $600 or more.

(B) Medicare Tax Changes - 2013

Currently, under the existing law, all earned income from employment and/or self-employment are subject to a total of 2.9% Medicare tax with no upper limit. However, unearned income such as interest, dividend, capital gain, rent and etc. are exempt from Medicare tax. Further, any taxpayer who is an employee will be required to pay only half (1.45%) of the Medicare tax. The other half (1.45%) will be paid by the taxpayer's employer.

The Healthcare Reform Act deleted the Medicare tax exemption from unearned income. Therefore, effective 2013, interest, dividend, capital gain, rental income and etc. will be subject to unlimited 3.8% Medicare tax with no cap. Since they are unearned income, there will be no employer to pay for half of the new tax. Therefore, taxpayers must be 100% responsible for the newly added Medicare tax.

There is an exemption for taxpayer whose total modified gross income (MAGI) is lower than $250,000 (married filing jointly) or $200,000 (unmarried or single). However, these set of income thresholds are preset and will not be adjusted for inflation. This means the $250,000 or $200,000 thresholds will remain unchanged while taxpayers' total income/gain will grow, in general, along the path of inflation. This way, many taxpayers will eventually be caught by the new unlimited 3.8% Medicare tax on unearned income/gain.

Imagine, when you are ready to retire and wish to downsize, you may want to sell your home, the capital gain resulted from the sale will easily bring your total gross income over the preset threshold, and the Federal capital gain tax rate will be much higher than the current 15%. As a result, on top of the higher Federal and State capital gain tax, you must also pay a 3.8% double tax.

Any questions or discussions, please give us a call at 415-381-0681

Sincerely

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