

MANY TAX CHANGES FOR INDIVIDUALS AND RETIREMENT PLANS GO INTO EFFECT IN 2011

Many important tax changes go into effect this year. Most are the result of new rules in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (2010 Tax Relief Act) as well as in seven other tax laws enacted in 2008 - 2010, while others are triggered by regulations. This *Hot Topic* reviews non-extender, non-indexing changes for individuals and retirement plans.

- ***Payroll tax holiday in place.***

For remuneration received during 2011, the 2010 Tax Relief Act reduces the employee OASDI tax rate under the FICA tax by two percentage points to 4.2%. (Similarly, for self-employment income for tax years beginning in 2011, the OASDI tax rate under the SECA tax is reduced by two percentage points to 10.4% percent.) As a result, for 2011, employees will pay only 4.2% Social Security tax on wages up to \$106,800 (and self-employed will pay only 10.4% Social Security self-employment taxes on self-employment income up to \$106,800).

- ***Stricter rules apply to energy saving home improvements.***

The 2010 Tax Relief Act extended the nonbusiness energy property credit for one year, through December 31, 2011. However, stricter rules apply for 2011 than for 2010. A taxpayer can claim a 10% credit for qualified energy property placed in service in 2011 up to a \$500 lifetime limit (with no more than \$200 from windows and skylights) over the aggregate of the credits allowed to the taxpayer for all earlier tax years ending after December 31, 2005. The credit is equal to the sum of: (1) 10% of the amount paid or incurred by the taxpayer for qualified energy efficiency improvements installed during the tax year, and (2) the amount of the residential energy property expenditures paid or incurred by the taxpayer during the tax year.

The credit for residential energy property expenditures can't exceed: (i) \$50 for an advanced main circulating fan; (ii) \$150 for any qualified natural gas, propane, or hot water boiler; and (iii) \$300 for any item of energy-efficient property. Exterior windows, skylights and exterior doors can qualify for the credit if they meet the Energy Star program requirements; are no longer required to meet the prescriptive criteria established by the International Energy Conservation Code (IECC); and no longer required to have a U factor and Solar Heat Gain Coefficient (SHGC) of 0.30 or below. Efficiency standards for furnaces, boilers, and stoves are tightened. There's no credit for expenditures made from subsidized energy financing.

- ***Partial annuitization of annuities.***

Under the "Small Business Jobs Act of 2010," for amounts received in tax years beginning after December 31, 2010, taxpayers may partially annuitize a nonqualified

annuity, endowment or life insurance contract. If any amount is received as an annuity for a period of 10 years or more, or during one or more lives, under any portion of an annuity, endowment, or life insurance contract:

- (1) that portion will be treated as a separate contract for annuity taxation purposes;
- (2) for purposes of applying the calculation of the exclusion ratio for annuity distributions, the investment in the contract is allocated pro rata between each portion of the contract from which amounts are received as an annuity, and the portion of the contract from which amounts are not received as an annuity; and
- (3) a separate annuity starting date is determined for each portion of the contract from which amounts are received as an annuity.

Thus, holders of nonqualified annuities can elect to receive a portion of an annuity contract in the form of a stream of annuity payments, leaving the remainder of the contract to accumulate income on a tax-deferred basis.

The partial annuitization rule is not intended to change the rules for amounts received as an annuity (or as a lump sum) from Code Sec. 401(a) qualified plans, Code Sec. 403(a) annuity plans, Code Sec. 403(b) annuity plans, or individual retirement plans.

■ ***Restricted definition of medicine for health plan reimbursements.***

Under the Patient Protection and Affordable Care Act, the cost of over-the-counter medicines can't be reimbursed with excludible income through a health flexible spending arrangement (FSA), health reimbursement account (HRA), health savings account (HSA) or Archer MSA, unless the medicine is prescribed by a doctor. For HSAs and Archer MSAs, this applies for amounts paid with respect to tax years beginning after December 31, 2010; for health FSAs and HRAs, it applies for expenses incurred with respect to tax years beginning after December 31, 2010.

■ ***Boosted tax on nonqualifying HSA and Archer MSA distributions.***

Under the Patient Protection and Affordable Care Act, for disbursements made during tax years starting after December 31, 2010, the additional tax on distributions from an HSA that are not used for qualified medical expenses is increased from 10% to 20% of the disbursed amount, and the additional tax on distributions from an Archer MSA that are not used for qualified medical expenses is increased from 15% to 20% of the disbursed amount.

■ ***Small employers may establish "simple cafeteria plans."***

Under Sec. 9022 of the Patient Protection and Affordable Care Act, for years beginning after December 31, 2010, small employers (average of 100 or fewer employees on business days during either of the two preceding years) may provide

employees with a "simple cafeteria plan." Under such a plan, the employer is provided with a safe harbor from the nondiscrimination requirements for cafeteria plans as well as from the nondiscrimination requirements for specified qualified benefits offered under a cafeteria plan, including group term life insurance, benefits under a self-insured medical expense reimbursement plan, and benefits under a dependent care assistance program.

- ***Ability to make qualifying charitable distribution in January 2011 and treat it as made in 2010.***

Taxpayers who are age 70 1/2 or older can make tax-free distributions to a charity from an Individual Retirement Account (IRA) of up to \$100,000. These distributions aren't subject to the charitable contribution percentage limits since they are neither included in gross income nor claimed as a deduction on the taxpayer's return. Under the 2010 Tax Relief Act, these rules are available for charitable IRA transfers made in tax years beginning before January 1, 2012. In addition, a taxpayer can elect for such a distribution made in January of 2011, to be treated as if it were made on December 31, 2010. Thus, a qualified charitable distribution made in January 2011, may be (1) treated as made in the taxpayer's 2010 tax year and thus so allowed to count against the 2010 \$100,000 limitation on the exclusion, and (2) treated as made in the 2010 calendar year and so allowed to be used to satisfy the taxpayer's minimum distribution requirement for 2010.

- ***Designated Roth accounts OK in 457 plans.***

Under the Small Business Jobs Act of 2010, for tax years beginning after December 31, 2010, governmental Section 457 plans are added to the definition of "applicable retirement plans" that can offer a qualified Roth contribution program. Thus, a Section 457 plan maintained by a state, its political subdivision, agency or instrumentality or the state subdivision's agency or instrumentality, can include a qualified Roth contribution program.

- ***Advance payment of Earned Income Tax Credit (EITC) is eliminated.***

Under the Education Jobs and Medicaid Assistance Act, effective for tax years beginning after December 31, 2010, the advance payment option for claiming the EITC is eliminated, along with the employer-required reporting of advance EITC payments on Form W-2, and the return-filing requirement for recipients of advance EITC payments.

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