

April 2010

## Contacts

### Jeffry M. Blair

1445 Ross Avenue, Suite 3700  
Dallas, Texas 75202-2799  
(214) 468-3306  
jblair@hunton.com

### Cameron N. Cosby

Riverfront Plaza, East Tower  
951 East Byrd Street  
Richmond, Virginia 23219-4074  
(804) 788-8604  
ccosby@hunton.com

### Alexander G. McGeoch

1445 Ross Avenue, Suite 3700  
Dallas, Texas 75202-2799  
(214) 979-3041  
amcgeoch@hunton.com

## New Health Care Law Results in Higher Taxes

On March 30, 2010, President Barack Obama signed into law the Health Care and Education Reconciliation Act of 2010 ("Reconciliation Act"). The Reconciliation Act modified the Patient Protection and Affordable Care Act (the "2010 Health Care Act") that President Obama signed into law on March 23, 2010. Both the Reconciliation Act and the 2010 Health Care Act add, increase and expand taxes that apply to a wide variety of taxpayers. These additional taxes include the following:

### **Surtax on Net Investment Income**

For taxable years beginning after December 31, 2012, a new 3.8% surtax will be imposed on investment income of individuals earning more than a certain threshold amount of modified adjusted gross income. The threshold amount is \$200,000 for taxpayers filing individually, \$250,000 for joint filers and \$125,000 for married taxpayers filing separately. The 3.8% surtax is imposed on the lesser of: (i) the taxpayer's net investment income or (ii) the excess (if any) of the taxpayer's modified adjusted gross income for that taxable year over the taxpayer's threshold amount. Modified adjusted gross income is defined as the taxpayer's adjusted gross income increased by the amount excluded from income as foreign earned income under Section 911(a) (1) of the Internal Revenue Code net of

deductions and exclusions disallowed with respect to foreign earned income.

For purposes of this surtax, "net investment income" includes interest, dividends, annuities, royalties, and rents, as well as gross income from a trade or business that would be treated as a passive activity with respect to that taxpayer (a "Passive Activity") and gross income from a trade or business of trading in financial instruments or commodities (a "Trading Business"). Net investment income also includes net gain to the extent such net gain is taken into account in computing the taxpayer's taxable income and is attributable to the disposition of property (other than property held in a trade or business that is not a Passive Activity or a Trading Business with respect to that taxpayer). Net investment income does not include distributions from IRAs or other qualified plans or any income taken into account for self-employment tax purposes. Net investment income also does not include, subject to certain limitations, the net gain or net loss from the sale of an interest in a partnership or S corporation that would be treated as an active trade or business with respect to the selling taxpayer. Net investment income is gross investment income reduced by deductions allocable to such investment income.

The 3.8% surtax also is imposed on estates and trusts on the lesser of (i) the undistributed net investment income for such taxable year; or (ii) the excess (if any) of the adjusted gross income (as defined in Section 67(e) of the Internal Revenue Code of 1986, as amended [the "Code"]) over the dollar amount at which the highest tax bracket in Code Section 1(e) begins for such taxable year. This additional tax may be particularly onerous to estates and trusts because these taxpayers reach the highest tax bracket very quickly. Currently, for 2010, the highest tax bracket for trusts and estates is only \$11,200.

Significantly, the threshold amount is not indexed for inflation, the tax is subject to estimated tax payment provisions and the new surtax is not deductible in computing income tax liability. This increase in taxes will cause many partnerships, S corporations and other flow-through entities to have to increase their distributions to their partners, shareholders and members to account for this increase in taxes.

#### **Increased Medicare Tax for Certain Employees and Self-employed Persons**

For taxable years beginning after December 31, 2012, the hospital insurance tax on wages will increase by 0.9 percent, from 1.45 percent to 2.35 percent, for wages that exceed a certain threshold amount. The threshold amount is \$200,000 in wages for taxpayers filing individually, \$250,000 for joint filers and \$125,000 for married filing separately. No deduction is allowed for this additional 0.9 percent tax.

The hospital insurance tax rate on self-employment wages for taxable

years beginning after December 31, 2012, will also increase by 0.9 percent, from 2.9 percent to 3.8 percent, on self-employment wages in excess of a threshold amount. The threshold amount is \$200,000 in wages for taxpayers filing individually, \$250,000 for joint filers and \$125,000 for married filing separately. No deduction is allowed for this additional 0.9 percent tax.

#### **Codification of the Economic Substance Doctrine**

Prior to the passage of the 2010 Health Care Act, courts generally denied tax benefits with respect to transactions that lacked economic substance independent of U.S. federal income tax considerations. However, the courts were not always consistent in their application of this doctrine. Because of this inconsistency, Congress included in the Reconciliation Act a provision to codify the economic substance doctrine in new Code Section 7701(o). Code Section 7701(o) is effective for transactions entered into after March 30, 2010.

Under new Code Section 7701(o), a transaction shall be treated as having economic substance only if (i) the transaction changes in a meaningful way (apart from federal income tax effects) the taxpayer's economic position and (ii) the taxpayer has a substantial purpose (apart from federal income tax effects) for entering into such transaction. For purposes of these tests, any state or local income tax effect that is related to a federal income tax effect shall be treated in the same manner as a federal income tax effect. In addition, a purpose of achieving a financial accounting benefit shall not be taken into account as a purpose

for entering into a transaction if the origin of such financial accounting benefit is a reduction of federal income tax.

For transactions entered into after March 30, 2010, the Reconciliation Act added a new strict liability penalty of 20 percent for underpayments, understatements, and excessive refunds and credits attributable to any disallowance of claimed benefits by reason of a transaction lacking economic substance (either as defined in Code Section 7701(o) or by reason of failing to satisfy the requirements of any similar rule of law). The penalty rate is increased to 40 percent if the taxpayer doesn't adequately disclose the relevant facts affecting the tax treatment in the taxpayer's tax return or in a statement attached to the return. The reasonable cause and good faith exception does not apply to any portion of an underpayment that is attributable to a transaction lacking economic substance.

Although transactions needed to have economic substance before the Reconciliation Act, the codification of this doctrine combined with the revisions to the penalty provisions could require taxpayers to reevaluate how they comply with these requirements. For example, since the reasonable cause exception does not apply to transactions lacking economic substance, an outside opinion or in-house analysis would not protect a taxpayer from imposition of a penalty if it were determined that the transaction lacks economic substance or fails to meet the requirements of any similar rule of law.

## **Increased Information Reporting on Payments to Corporations**

---

In general, persons engaged in a trade or business must file an information statement with the Internal Revenue Service (“IRS”) with respect to payments made in the course of that trade or business for fixed and determinable income aggregating \$600 or more in any taxable year. Payments include payments for interest, rent, royalties, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, pensions and other gains, profits or income that total \$600 more in a tax year. The payer must also provide a copy of the information

statement to the payment recipient. Currently, payments to corporations are not treated as made to a “person” and have been exempted from most of these reporting requirements. As a result of the Reconciliation Act this exception for corporations (other than a tax-exempt corporation) has been eliminated for payments made after December 31, 2011. Accordingly, for payments made after December 31, 2011, a business must file an information return for all payments aggregating \$600 or more in a calendar year to a corporation (other than a tax-exempt corporation). This new rule applies notwithstanding any IRS Regulation issued prior

to March 23, 2010, for information reporting purposes to the contrary.

## **Accelerated Estimated Tax Payment for Large Corporations**

---

As a result of the Reconciliation Act, the corporate estimated tax payment due for large corporations in July, August or September 2014 has been increased from 157.75 percent to 173.50 percent of the payment otherwise due. For purposes of this change, large corporations are corporations with assets of at least \$1 billion (determined as of the end of the previous tax year).

© 2010 Hunton & Williams LLP. Attorney advertising materials. These materials have been prepared for informational purposes only and are not legal advice. This information is not intended to create an attorney-client or similar relationship. Please do not send us confidential information. Past successes cannot be an assurance of future success. Whether you need legal services and which lawyer you select are important decisions that should not be based solely upon these materials.