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Client Information Bulletin

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Highlights of the 2003 Medicare Law

New health-related tax initiatives for individuals and businesses

The controversial Medicare Prescription Drug and Modernization Act of 2003—signed into law by the president shortly before the end of last year—represents the most significant change in the federal Medicare program since its inception in 1965. The new legislation includes several new health-related tax initiatives for both individuals and businesses scheduled to begin over the next decade. The estimated cost of this new legislation is close to \$400 billion.

Here are some of the major provisions featured in the new Medicare law.

Prescription drugs: Under this provision, the Social Security

Administration must provide subsidies to each sponsor of a prescription drug plan covering eligible retirees. In general, the subsidy will be equal to 28% of a retiree's prescription drug costs above \$250, but not greater than \$5,000 (adjusted annually based on increases in the Medicare prescription drug costs).

This provision does not go into effect until 2006. However, qualified retirees can purchase a discount drug card that will be available as early as this spring.

Health Savings Accounts (HSAs): The new Medicare law authorizes the creation of HSAs, which operate like individual retirement accounts (IRAs) for health care costs. In brief, contributions to a participant's account are tax deductible and withdrawals are tax-free to the extent that the funds are used to pay qualified medical expenses (see the box on the next page for more details on HSAs).

Out-of-hospital costs: The new law requires high-income participants to pay more of their own costs under Medicare Part B,

which covers out-of-hospital costs such as doctor visits and physical and occupational therapy. Premium increases, affecting retirees with incomes above \$80,000, are scheduled to go into effect in 2007 and phase in over a five-year period.

Physical exams and screening: Upon joining the Medicare program, plan participants will have the opportunity for a free doctor visit as well as to be screened for diabetes and cardiovascular disease. Payments to doctors for mammograms will be increased to encourage the use of these tools. This provision takes effect in 2006.

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Private plans: One provision in the new law is designed to promote private plans as an alternative to Medicare. This pilot program, scheduled to begin in 2010, will result in increased premiums for retirees who opt for the traditional Medicare program. Furthermore, the new law also sets aside \$12 billion in funds to encourage private plans to participate in Medicare.

In addition to these main provisions, the new Medicare law:

- ◆ exempts employers from providing 1099 forms to service providers if the services are paid by debit card, credit card or store-value card;
- ◆ increases payments to certain rural hospitals and physicians and hospitals serving a large number of low-income patients;
- ◆ replaces a scheduled 4.5% reduction in Medicare payments to doctors for 2004 with increases of at least 1.5% over the next two years;
- ◆ revises drug patent laws to enable generic drugs to compete more easily with brand-name drugs; and
- ◆ retains the current prohibition on the importing of prescription drugs that do not meet safety requirements.

This is just a brief overview of the new Medicare law. This far-reaching legislation is expected to have an impact for years to come. Consult with a tax professional concerning the implications to your personal situation.

How Much Is Your Business Worth?

Different methods can be used to set selling price

You trust that your business is worth more than the value of its tangible assets. But how can you put a price on the goodwill that could enable a buyer to easily walk into a successful operation?

One formula sets the selling price at the most recent year's net profit multiplied by one or two, plus inventory. As simple as this may be, it shows prospective buyers that you have made money and they should be able to as well.

Capitalization factor is another method. Divide the annual net profit by your asking price. This is the rate of return a buyer could expect on the investment. A lower price will increase the yield, and a sharp buyer will expect a higher return for the added risk that the earnings might not turn out as projected. Since both of these approaches can produce wide variations, here are some factors you should consider when estimating your business's value.

Health Savings Accounts Have Arrived

One of the key components of the new Medicare law is the Health Savings Account (HSA). This new tax-saving vehicle is available to the general public in 2004.

How it works: Contributions may be made to an HSA on a tax-deductible basis. There is no current income tax on any earnings on the contributions. Distributions from a participant's account are tax-free if they are withdrawn to pay qualified medical expenses.

HSAs may be used by individuals not yet eligible for Medicare who are covered under a "high-deductible" health plan, defined for this purpose as a health plan with a deductible of at least \$1,000 and an out-of-pocket maximum of \$5,000 for individual coverage; a deductible of at least \$2,000 and an out-of-pocket maximum of \$10,000 for family coverage.

The maximum allowable contribution is generally limited to the amount of the annual deductible. Catch-up contributions are permitted for individuals age 55 or older.

Although HSAs resemble Archer Medical Savings Accounts (MSAs) and flexible spending accounts (FSAs), they have several advantages. Significantly, contributions can be made by both employers and employees, insurance deductibles are lower than those permitted by Archer MSAs and, unlike FSAs, unused funds can be rolled over from year to year.

Do you lease your space? A short-term contract might tell a buyer that expenses may increase in the near future. A long-term lease at below-market rates could make your business more valuable.

If you own your building, it will add to your business's worth. However, you should treat it as a separate issue, since a buyer may want to move to a less expensive location or merge with another concern.

Do you run every aspect of your business? Or is there a management team in place? The company can be worth more if the know-how and goodwill are easily transferable. You may want to offer to stay on as a consultant to help a new owner understand the operation.

Of course, it comes down to how much a buyer is willing to pay and how much you will accept. But for a reasonably quick sale with minimal negotiations, you may want to bring in a professional, such as an accountant, to help set a realistic price for your business.

Tax Relief Is Available When Disaster Strikes

Casualty losses of business and personal property may be deductible

The tax code contains provisions that help alleviate financial hardship when a disaster strikes. Of course, this tax relief is available for major catastrophes such as hurricanes and earthquakes. But it can also be a big help when a fire damages your business premises or a heavy rainstorm floods your basement. Anytime you suffer a “casualty” that involves significant damage, you may be eligible for tax relief.

How much can you deduct? You can claim a loss deduction for property damage resulting from a casualty. Your deduction is reduced by any related payouts from insurance. Casualty losses to both business and personal property are deductible, but the type of property determines the amount of the deduction.

In the case of an office building, machinery or other business property, you (or your company if it’s the owner) can write off the current tax basis of the property if it is entirely destroyed. When the property is not destroyed, the loss deduction is limited to the drop in the property’s fair-market value up to the amount of the property’s tax basis. The cost of repairs is generally a good measure of a property’s drop in value.

The rules are different for homes, family cars and other personal property. Even if the property is completely destroyed, your deductible loss cannot exceed the lesser of the drop in value of the property or the property’s cost.

In addition, you must reduce the casualty loss by \$100 (if you suffer more than one loss in a single event, only one \$100 reduction is made). Finally, you can write off the net deductible loss only to the extent it exceeds 10% of your income.

Example: Joan Parker has an income of \$80,000. She purchased her home for \$200,000. A fire caused damage that will cost \$50,000 to repair. Parker’s insurance company pays her \$20,000. Parker’s net deductible loss is \$29,900 (\$50,000, less \$20,000, less

\$100). Her deduction is limited to \$21,900 (\$29,900, less 10% of her income).

A loss deduction is not reduced by any food, medical supplies or other forms of subsistence that don’t compensate someone for property damage. By the same token, you cannot claim a casualty loss deduction for the cost of medical or temporary living expenses. Your deduction is increased by the cost of clearing property of debris.

When can you claim your deduction? A casualty loss is generally deductible in the year you sustain the loss. However, if there is a reasonable prospect of an insurance recovery, the deduction must be reduced by the amount you expect to receive. If you receive a less-than-expected amount in the later year, you can claim a casualty loss for the difference in the later year. If you receive more than was expected, the excess recovery is taxed to you as extra income in the later year, but only to the extent your taxable income was actually reduced by the casualty loss deduction claimed in the earlier year.

There is special relief for taxpayers in federally designated disaster areas. If you suffer a loss in a federal disaster area, you can choose to deduct this loss on the return for the tax year preceding the year of the disaster. For example, victims of a hurricane in 2004 can get a writeoff on their 2003 return. They can file an amended 2003 return and get a refund.

Insurance recoveries: You generally owe no tax on amounts received from an insurance company for damage to your property. However, if the insurance proceeds exceed your basis of the property, the excess is taxable. It’s treated like a sale of the property at a profit. But you can postpone the tax on this “profit” by reinvesting the proceeds in similar property within two years. No tax is owed until the replacement property is sold.

Please contact us if you want more information about the tax ramifications of property damage.

IRS Lets Families Pay Estate Tax on the Installment Plan

Qualification depends on decedent's closely held business interest

A recent IRS ruling illustrates how some families can spread out estate-tax payments over as long as 14 years. When the owner of a closely held business dies, a special provision of the tax code may allow his or her family to pay the estate tax in installments. This helps the family pay the estate tax without liquidating the business.

How it works: The deferral of tax payments is available for the portion of the estate tax attributable to the decedent's closely held business interest. The executor can choose to pay that portion of the estate tax in up to 10 annual installments. The first installment can be postponed for up to five years after the estate-tax return is due.

Not every estate of a business owner, however, qualifies for the installment payment provision. Installment payments are available only if the value of closely held business interests makes up more than 35% of the business owner's estate. For this purpose, a closely held business interest includes a sole proprietorship or a more than 20% interest in a partnership or corporation. The installment payment provision is available only to the extent the decedent was carrying on an active trade or business. The provision cannot be used for passive assets of a business.

A recent ruling involved a different situation. The decedent, whom we will refer to as Bob Brown, owned two commercial real estate corporations. The two corporations employed 10 full-time employees to conduct various aspects of the real estate operations. Five employees managed all corporate activities on a day-to-day basis while the

other five employees performed maintenance work.

When Brown died, the two corporations made up more than 35% of his estate. But the question arose: Did the corporations' real estate properties, all of which were leased to other parties, constitute passive assets?

The IRS ruled that most of the properties were not passive assets. The IRS noted that when an individual simply manages his or her investments, that's not considered an active business activity. And when an individual contracts out the management of properties to others, the properties are not treated as used in an active business. But this was not the case in Brown's situation.

The two corporations provided services that went beyond the mere management of investments. Brown was personally involved in negotiating leases, supervising maintenance work, marketing the properties, billing and collecting rents and other activities. Through its employees, the corporations provided extensive repair and maintenance services and 24-hour emergency services.

These services, however, were not provided in the case of one property. According to the IRS, that property was a passive asset and did not qualify for the installment payment provision.

Of course, the key to taking advantage of this estate-tax break is making sure that the value of a closely held business represents more than 35% of the total estate. We can help you develop an estate plan that meets the test.

Facts and Figures

Timely points of particular interest

- è **Interest on Back Taxes**—In a new case, an attorney had to pay \$1.5 million in interest after the IRS audited his sole proprietorship. He deducted the interest as a business expense, but the deduction was denied by the Fifth Circuit Court. Reason: The payment was considered nondeductible personal interest. By way of comparison, interest on tax payments made by corporations is deductible (Alfaro, CA-5, 11/6/03).
- è **Missing Records**—A plasterer presented no books or records to substantiate his claims for prior expenses and losses to offset his current business income. Furthermore, he did not make any effort to reconstruct records that were claimed to be lost. As a result, he could not benefit from the “Cohan rule,” which would allow the Court to estimate a deductible amount (Cottrell, T.C. Summ. Op. 2003-162).