

## Jobs and Growth Relief Act: Business Incentives

### Benefits to Individuals

The 2003 Jobs and Growth Relief Act, designed to be an economic stimulant, has as one of its clear objectives, providing tax relief to the consumer. Consumer spending is a key to economic recovery. There are a number of provisions which should accelerate consumer spending.

One highly publicized provision is the immediate increase of the child tax credit from \$600 per child to \$1000. A married couple with adjusted gross income of less than \$110,000 should have received a refund of \$400 per child. Those who did not can receive this benefit when they file their 2003 income tax return.

The provision with the most impact on individuals are the individual income tax rate reductions. The 27%, 30%, 35%, and 38.6% tax rates have been lowered to 25%, 28%, 33% and 35% respectively in 2003.

Other benefits for individuals include an attempt to alleviate the "marriage penalty," by making the standard deduction for joint filers twice that of single filers, and increasing the size of the 15% bracket for joint filers to twice that of single filers. These changes minimize the inequity of joint filers paying more taxes than they would if they were filing separately.

Long term capital gains (from stock held for more than a year) has been reduced to 15% and income from qualifying dividends, which were taxed using ordinary income tax rates, has also been reduced to 15%.

### Depreciation "Bonus"

While considerable attention in reporting the new tax law has been paid to the benefits to the individual taxpayer, the changes that affect businesses, particularly small businesses, also should have substantial effects. These changes primarily affect depreciation.

Traditionally taxpayers recover the cost of assets used in a trade or business through annual depreciation deductions on their tax returns. The allowable deduction is calculated using rules called the "Modified Accelerated Cost Recovery System (MACRS). Factors in the calculation are cost, the recovery period (5 to 7 years for most machinery and equipment), the depreciation method, and the placed in service convention applicable to that type of property.

In 2002 Congress introduced a first year 30% "bonus" depreciation, allowing business to take 30% of the cost basis of the qualified property as a depreciation expense in addition to the regular depreciation. The "bonus" applied to property acquired after September 10, 2001 and before September 11, 2004 and that was placed in service before January 1, 2005. The bonus depreciation is subtracted from the basis when calculating the regular depreciation.

The 2003 Act expands this bonus depreciation. Taxpayers can elect an additional first year depreciation of 50%. Under the new law the original use of the property must have commenced after May 5, 2003, and the property must be acquired after May 5th and before January 1, 2005.

Many states, including Pennsylvania, did not allow the original 30% bonus, and those who did may not increase it to 50%. It may be necessary to calculate depreciation separately for federal tax and state tax purposes.



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## Section 179 Expensing

Small Businesses can take advantage of the election under Section 179 of the tax code to expense the cost of depreciable assets in the year of acquisition under certain restrictions. Prior to this year there was a limit of \$25,000 which could be expensed, and that amount was reduced dollar for dollar if the cost of depreciable property in that year exceeded \$200,000. Also the amount expensed could not exceed the profits of the business, calculated before expensing depreciation. Clearly the law was designed to benefit profitable small businesses with modest capital investments.

The 2003 law increases the amount that can be expensed in the first year to \$100,000 for property placed in service during tax years 2003, 2004, and 2005. The annual investment limit has been raised to \$400,000.

These liberalized depreciation rules will often require tax planning by small businesses to ensure that a current deduction can be fully utilized and results in the optimum tax benefit.

## Dividends and Capital Gains

The changes in the taxable rates on income from dividends could have an effect on the decisions of C-corporations to distribute or increase dividends. Also lower capital gains tax rates represent a benefit to sellers of stock in closely-held businesses.

In addition to its effect on individual taxpayers, the Tax Act of 2003 should provide significant benefits to smaller businesses, promoting capital investment and expansion.

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## “Health Insurance Premium Increases: Is there a Cure?”

### Escalating Healthcare Costs

For years, most Americans have considered healthcare to be an inherent component of their compensation — an essential and indispensable benefit. In the 1990s, health insurance companies introduced the concept of “Managed Care,” making the Primary Care Physician the “gatekeeper,” monitoring referrals to costly specialists. The idea was to manage cost. The “trade off” for the insured was policies with no deductions, no co-payments and prescription drug coverage.

The effect of the strategy was to dramatically increase utilization of the health system. The average family of four makes four doctor's office visits per month; has one inpatient admission over three years; has 32 to 36 outpatient procedures per year; and has four drug prescriptions filled every month.

These utilization rates translate to costs that are accelerating in a geometric progression. Premiums for the last three years have averaged a 25% increase. When compounded

over the three years, premiums have increased 95%. A family of four that paid \$6,000 in 2000 is paying \$11,719 in 2003. If the same rate of increase continues until 2010, the premium cost to this family of four would be \$55,879. Clearly, this trend must be halted. The increased burden on employers has made it impossible for them to continue to provide health benefits under their old plans. Many have employed “stop gap” measures that provide no long-term solutions. Is there a longer term “cure”?

### Health Reimbursement Accounts

One of these strategies is to establish Health Reimbursement Accounts (HRAs). An HRA is an employer-funded arrangement, whereby the employer provides reimbursement to the employee for eligible medical expenses. The employer may define the eligible expenses. The employer establishes a fixed dollar amount for each employee for the plan year.

Unused funds may, but are not required to be, carried forward into the next plan year.

There are four types of HRAs. The Bridge Plan combined with a higher deductible insurance product provides a “bridge” between out-of-pocket expenses of the employee and the insurance coverage.

The Comprehensive Plan covers all medically necessary expenses as outlined in IRC Section 213(d).

The Limited Plan is designed to cover very specific medical expenses that are not covered by the insurance, such as vision or dental.

The Insurance Only Plan assumes that the employee has individually-owned insurance and the employer provides a specific contribution toward its premiums.

The plan most relevant to the changes in the health insurance industry is the Bridge Plan, because it provides a way for the employer to “self-insure” a portion of the new deductible.

There are several advantages to the employer:

1. The employer is able to assist the employee with the transition to “consumerism,” making it more palatable.
2. The employer is able to adopt a higher deductible plan lowering the cost of premiums to the employer.
3. The plan does not need to be pre-funded. The employer makes payments as claims are made.
4. The employer has considerable flexibility over any unused portion of the dollar amount allocated to each employee:
  - a. The employer may retain these.
  - b. They can be rolled forward during the term of the employee’s employment.
  - c. A designated percentage or dollar amount may be rolled forward.
5. Typically only 30% to 40% of the designated HRA funds are used annually.
6. The employer can define whether the HRA funds are used to reimburse for the deductible, before the employee’s portion is used, or whether the employee’s portion will be used first. Or the employer may reimburse a percentage of the deductible for each claim.

The advantages to the employee are:

1. The employee’s deductible is effectively reduced.
2. The employee does not pay taxes on the employer’s reimbursement, as they would if the employer simply increased the employee’s compensation to cover a portion of the deductible.



### **Flexible Spending Accounts**

Another strategy is the adoption of Flexible Spending Accounts (FSAs). These are provided for under Section 125 of the Internal Revenue Code, and can be components of existing “cafeteria” plans. These may be used in combination with HRAs. They are a vehicle for the employee to self-insure a portion of the deductibles and co-pays, and any other eligible expenses not reimbursed by insurance or an HRA account. Eligible expenses may include daycare and individually owned health insurance premiums.

The account permits the employee to set aside monies out of pre-tax income to fund eligible out-of-pocket expenses. The employee does not pay income tax or payroll taxes on these funds.

The employer does not pay the employer’s share of payroll taxes on this portion of the employee’s compensation.

The employee may not roll over funds from an FSA account from year to year. It is important not to over-fund these accounts.

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## Regulations

Both HRAs and FSAs have formal requirements, established by the IRS:

1. There must be a formal plan with plan documents including a Summary Plan Descriptions that is distributed to all participants.
2. Elections to participate must be made at the beginning of the plan year, with only certain "Change of Status" conditions permit entering the plan during the year.
3. The plan may not discriminate against highly compensated or key employees.
4. In some cases, an IRS Form 5500 must be filed annually.

Whether "consumerism" will turn out to be a long-term solution to increased healthcare costs remains to be seen. The only certainty is that it will have a significant financial impact on the "consumer," particularly those who have the greatest need to utilize the system. Tax relief is available to employees if the proper plans are put into place. Utilizing the combination of insurance plans with deductibles and co-payments and HRAs can benefit both employer and employee. Employers and employees can experience additional tax savings if FSAs are added.

— Joseph C. Paparone II

*Editor's Note — Joe is the partner in charge of the Grove City Office. As an advisor to many privately held companies, he has encountered the need among his clients to design new approaches to health insurance benefits.*



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