Walters Levine Klingensmith & Thomison

Attorneys at Law

Report From Counsel

Insights and Developments in the Law **Spring 2013**

ObamaCare's 3.8% Medicare Surtax

By Alan F. Gonzalez, LL.M., Esquire ©2013

In 2010, the U.S. Congress passed the Patient Protection and Affordable Care Act ("Obamacare") and in that legislation a new surtax was added to the Internal Revenue Code ("IRC") in

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the form of IRC §1411. IRC §1411 imposes a 3.8% surtax beginning on January 1, 2013, on certain passive investment income of individuals, trusts and estates as is further explained below. This new "Medicare Surtax" is based upon a computation that involves a computational taxing formula that involves a taxpayer's net investment income ("NII") and what is called a taxpayer's modified adjusted gross income ("MAGI"). For individual taxpayers, the 3.8% Medicare Surtax is imposed upon the lesser of the taxpayer's NII for a taxable year, or the excess, if any, of the taxpayer's MAGI for such taxable year that exceeds the designated "threshold amounts". The threshold amounts for individual taxpayers depend on the taxpayer's filing status and are identified as follows: (1) $250,000 for married persons filing jointly (2) $125,000 for married persons filing separately, and (3) $200,000 for single, unmarried taxpayers. For trusts and estates, IRC §1411(a)(2) imposes the Medicare Surtax on the lesser of the undistributed NII trust or estate income for such taxable year, or the excess, if any, of the adjusted gross income of the trust or estate as defined by IRC §67(e) for such taxable year over the dollar amount at which the highest tax bracket begins for such taxable year. Quite simply, it is obvious from a plan-

Continued on page four.

Arbitration Agreements Can Go Too Far

Strong public policies support the appropriate use of arbitration over litigation in settling legal disputes and, in fact, such policies underlie the Federal Arbitration Act. That said, an agreement to arbitrate disputes is subject to well-established principles rooted in the law of contracts. This means, among other things, that courts will step in and declare void an ostensible agreement to arbitrate if its effects are too heavily weighted in one party's favor. Two recent examples of this overreaching by the more powerful party illustrate the point.

In the first case, a former employee sued his former employer under the Fair Labor Standards Act for overtime wages. A federal appellate court prevented the employer from enforcing an arbitration agreement that was in the company's employee handbook. The fatal flaw in the arbitration provision was that rather than being a legitimate contract, the bargain was "illusory," a legal term meaning that one party, the employer, could effectively avoid its promise to arbitrate by amending the provision or even terminating it altogether.

Although the employer was required to provide an official written notice of any changes to the handbook, a change-in-terms clause gave the employer the "right to revise, delete, and add to the employee handbook" with retroactive effect. There was no savings clause excepting pending disputes from any changes made by the employer.

In the second case, the lopsided bargain that led a court to declare an arbitration agreement unenforceable was more a matter of dollars and cents. A couple purchased a home, contingent upon a satisfactory home inspection. They engaged the services of a home

Continued on page four.

1819 Main Street, Suite 1110 • Sarasota, FL 34236 • Phone: (941) 364-8787 • Fax: (941) 361-3023
601 Bayshore Boulevard, Suite 720 • Tampa, FL 33606 • Phone: (813) 254-7474 • Fax: (813) 254-7341
203 N. LaSalle Street, Suite 2350 • Chicago, IL 60601 • Phone: (312) 782-8807 • Fax: (312) 782-8744
Website: www.walterslevine.com

Facebook Posting Leads to an "F"

We all know that the right of free speech has its limits. There is no right to shout "Fire!" in a crowded theater. Those limits apply even in settings most closely associated with the free exchange of ideas, such as colleges and universities. In that academic setting, limits also exist even for speech that takes place off campus, such as on a social networking website, but that is connected to a student's academic program.

A student in a state university's mortuary science program learned these constitutional law lessons the hard way when the university gave her a failing grade in an anatomy class and imposed other sanctions against her for comments she had posted, to hundreds of her "friends," on her Facebook account.

The hard lesson for the student continued when a state high court rejected her lawsuit asserting that the disciplinary measures were invalid because they were an infringement of her right to free speech. Of course, words matter, so what the student had actually said was pivotal to the outcome of her case.

While she was taking an anatomy lab, the student posted what she thought were humorous comments about a cadaver she had been assigned to dissect. That was bad enough, but the student also posted a comment about wishing to "stab a certain someone in the throat" with an embalming instrument.

Not surprisingly, university officials were not amused when they learned of the postings, though the student portrayed her remarks as "satirical." But the university's defense of the subsequent disciplinary actions rested on more than just the sensibilities of the university officials—though, to be sure, the whole story caused much embarrassment and a public relations problem for the school.

The student's postings, in which she gave the cadaver a name derived from a comedy film about a corpse and wrote about "playing" with the cadaver, taking her "aggression" out on it, and keeping a "[l]ock of hair" in her pocket, resulted in letters and calls to the university's anatomy bequest program from donor families and the public.

Most importantly from a legal standpoint, the student's conduct violated clear program rules prohibiting both disrespectful conversational language outside the laboratory about cadaver dissection and Internet blogging about cadaver dissection or the anatomy lab. In order to be in the mortuary science program, the student was aware of, and had to agree to abide by, such rules. There is no free speech infringement when the conduct in question, as in this case, violates academic program rules that are narrowly tailored and directly related to established professional conduct standards.

Even as it rejected the student's First Amendment contentions, the court acknowledged some settled principles of law that could allow free speech claims by students to succeed

Continued on page three.

Financial Fraud Against the Elderly

It is a sad and sobering reality that scam artists intent on committing financial fraud or the outright stealing of money, property, or valuable information prey upon vulnerable senior citizens. The threats can take many forms, but the elderly and those watching out for them can have some measure of protection by taking a few basic precautions.

- Do your homework when selecting a professional advisor, even if the advisor comes highly recommended by a friend or family member. This means confirming that the person is registered or licensed and has not left a trail of mistreatment of other clients.
- Powers of attorney (POA) are helpful, maybe even essential, as age takes its toll on an individual's capacity to handle financial matters. But the potential for misuse of a POA is great, since the appointed person generally has free rein to do whatever the elderly person could do on his or her own. The selected person must be trustworthy, and it is a good idea to have an attorney review the POA document.
- The array of account numbers, Social Security numbers, pins, passwords, and other such sensitive information that most of us accumulate over time can serve as a thief's key for raiding your savings and investments. Guard this information carefully.
- It may be an after-the-fact measure, but check your credit card and bank account statements carefully for any unauthorized or suspicious transactions. If you see one, contact the financial institution right away.
- Reverse mortgages allow homeowners who are at least 62 years old to borrow money from the equity in their homes. This device has its place under the right set of circumstances, but a reverse mortgage can also become a device for scam artists. Be wary of deceptive, too-good-to-be-true offers and high-pressure tactics.

Employers Combat FMLA Abuse

The federal Family and Medical Leave Act (FMLA) gives eligible employees the right to up to 12 weeks of leave per year, which may be taken intermittently for certain specified reasons, including the care of designated family members with serious health conditions.

The FMLA also prohibits an employer from interfering with, restraining, or denying the exercise of or the attempt to exercise any right given under the FMLA. One of the bases upon which an employer can defeat an FMLA "interference" claim is a showing by the employer that an employee did not, in fact, take leave for a purpose authorized under the FMLA. Naturally, the availability of this defense has prompted some employers to undertake investigations of (some might say "spying on") employees suspected of abusing the rights afforded by the FMLA.

At least two federal courts of appeals have effectively allowed at least some degree of employee surveillance by holding that in order to defeat an FMLA interference claim based on an employee's asserted right to reinstatement, an employer need only show that it refused to reinstate the employee based on an "honest suspicion" that the employee was abusing his or her leave. Sometimes the basis for such a suspicion is produced by detective work of the kind engaged in by private investigators.

In one such case, the employer had an honest suspicion that an employee had misused his FMLA leave and, therefore, the employer's decision to terminate the employee did not interfere with the employee's right to reinstatement. The employer suspected that based upon the employee's prior absenteeism, the employee was misusing his FMLA leave, so the employer hired a private investigator to observe the employee on a day for which he had requested FMLA leave to care for his mother. Video surveillance revealed that the employee did not appear to leave his house that day.

The decisive question that sealed the employee's fate was not whether he had actually committed fraud, but whether his employer reasonably and honestly believed that he had.

When the employer questioned him, the employee could not recall what he had done on that day, but he asserted that he had not misused his FMLA leave. Although the employee later provided supportive documentation from his mother's nursing home and doctor's office, the paperwork did not clear the air but, rather, only raised further questions for the employer, as the documents were facially inconsistent and conflicted with the employer's internal paperwork.

In a second case, an employer was found to have had an honest belief that an employee had committed disability fraud in taking FMLA leave and, therefore, his termination for such fraud was found not to have been a pretext for FMLA retaliation.

It was not disputed that the employee suffered from a herniated disc and sciatica. However, although the employee had been approved for disability leave based upon his having reported excruciating pain and an inability to stand for more than 30 minutes, coworkers saw him at an Oktoberfest festival a few days later without any indication that his movements were painful or restricted. In fact, he was also able to walk 10 blocks and remain at the crowded festival for 90 minutes.

The employer's investigation included interviews with the coworkers, and the employee was permitted to submit documentation and other evidence in his defense. Still, when the dust settled, the court ruled that the employer had acted within its rights in terminating the employee. Importantly, the decisive question that sealed the employee's fate was not whether he had actually committed fraud, but whether his employer reasonably and honestly believed that he had.

Facebook

Continued from page two.

when based on more defensible factual scenarios. A university's interest in academic freedom does not immunize the university altogether from First Amendment challenges.

For example, a university generally cannot use a code of ethics as a pretext for punishing a student's protected speech; nor can it impose a course requirement that forces a student to agree to otherwise invalid restrictions on her free speech rights. But a university can discipline students for violation of professional conduct standards that are in keeping with the academic environment of the student's particular program of study.

Actual resolution of legal issues depends upon many factors, including variations of facts and state laws. This newsletter is not intended to provide legal advice on specific subjects, but rather to provide insight into legal developments and issues. The reader should always consult with legal counsel before taking action on matters covered by this newsletter.

Medicare Surtax

Continued from page one.

ning standpoint that the greater the NII and MAGI earned by a taxpayer that is beyond the specified thresholds, the greater the taxpayer's Medicare Surtax liability will be.

A taxpayer's NII includes such income items as rents, interest, dividends, capital gains, royalties and passive activity income. If income items such as rents, interest, dividends, etc., are earned by virtue of active trade or business activities conducted by the taxpayer, then such income items will not be considered NII and, thus, those income items shall not be subject to the Medicare Surtax. The following are some other examples of income items that are not considered part of NII, to-wit: active trade or business income, self-employment income, income distributions from IRAs and qualified plans, and gain on sale of an "active" interest in a partnership or S corporation. In short, any item of income that is deemed passive activity income shall be classified as NII.

There are special rules in place for calculating NII when determining net gains on dispositions of S corporations and partnerships by a taxpayer. In those dispositional scenarios, the S corporation or partnership is deemed to have sold all of its properties for fair market value immediately before any disposition of the taxpayer's interest in the subject entity and then the allocable share of gain for each property is passed through to the shareholder/partner owner as a separate reportable item of income.

There are recently proposed regulations that have been promulgated by the IRS that provide for additional rules regarding the application of the Medicare Surtax to trusts. These proposed regulations exempt from the Medicare Surtax any grantor trusts and IRC §501 tax exempt trusts. The proposed regulations also create a new rule for charitable remainder trusts ("CRT") that are otherwise exempt from the imposition of the Medicare Surtax. The NII of a beneficiary earned through a CRT may be subject to the Medicare Surtax if the beneficiary's threshold amount mentioned above is exceeded by the NII attributable to the beneficiary that is received from a CRT annuity or unitrust amount. The CRT beneficiary's NII amount is calculated to include an amount that is the lesser of: (1) the total amount of the distributions for the taxable year, or (2) the current and accumulated NII of the CRT.

MAGI, as a practical matter, is generally equivalent to a U.S. taxpayer's adjusted taxable income ("AGI") as would be reported on the taxpayer's IRS Form 1040. MAGI does not include any tax exempt income items or non-taxable distributions to the taxpayer.

The individual tax planning implications are obvious in principle if the Medicare Surtax is to be avoided or minimized. The general planning principle is to reduce a taxpayer's Medicare Surtax liability by employing investment and other planning strategies in order to hopefully reduce both NII and MAGI which will then effectively reduce the taxpayer's potential Medicare Surtax liabilities. It is beyond the scope of this article to delve into specific Medicare Surtax reduction strategies. Nevertheless, the issue of Medicare Surtax avoidance or minimization is an issue of critical importance for each taxpayer to address with his or her accountant, attorney and financial advisor as soon as possible since the Obamacare Medicare Surtax is a tax reality for all taxpayers as of January 1, 2013.

Arbitration

Continued from page one.

inspection company, which had an arbitration clause in its standard contract. The couple signed the contract, but its most objectionable parts were tucked away in the contract, either in fine print, or hidden among other clauses, or both.

The contract's provisions relating to arbitration were so one-sided in favor of the home inspection company that it effectively "exculpated" the company from liability in a way that violated public policy. In particular, the contract limited the clients' recovery from the inspector for a negligent inspection to the $285 contract fee; it also required binding arbitration of any dispute, even requiring the party seeking arbitration to pay, among other costs, an initial arbitration fee of $1,350, plus $450 per day after the first day of a hearing.

In short, clients could well end up paying out in fees and costs many times the maximum amount they could recover from the company. Also influencing the court's decision were the facts that home inspection services are generally thought suitable for public regulation and that the services provided by home inspectors are a matter of practical necessity for their clients and are crucial to the clients' decision to purchase a home.

To top it off, the court noted that the wife, who had been primarily responsible for the house purchase, had only a high school diploma and no expertise or experience in home construction and that the couple had never purchased a home and were entirely at the mercy of the inspector, without any means of protection if the inspector performed a careless inspection.