



tax aspects of the health care reform act

MSK Client Alert

April 2010

practice areas

transactional tax

Basic health care insurance coverage is now the law of the land, thanks to the recently enacted Patient Protection and Affordable Care Act and Health Care and Education Reconciliation Act of 2010 (collectively the "Act"). A cornerstone is the creation of state insurance exchanges to allow small businesses and individuals to pool together and hopefully obtain less costly health insurance coverage.

The new health care regime is to be subsidized in large part through a set of taxes and tax increases for many individuals and businesses, with certain additional taxes applicable only to specific segments of the health care industry. There are even a few tax breaks.

The following is an overview of some of the key federal tax aspects of the Act.

Taxes Directly Related To Insurance Coverage

The tax provisions directly relating to health insurance coverage are a good entry point to the Act.

Individual Responsibility to Be Insured. U.S. citizens and legal residents are required to have health insurance beginning in 2014. Those without coverage at that time are subject to a penalty tax equal to the *greater* of \$95 per adult or 1% of income over the base amount required for filing a tax return. The tax increases over time, topping at the greater of \$695 per adult or 2.5% of eligible income in 2016. Special rules apply to certain low-income individuals, individuals residing outside of the U.S., those with religious objections to coverage, and others. There is a cap on the total tax payable by a family each year.

To help low-income individuals afford health insurance, beginning in 2014, an income tax credit is available. It covers taxpayers with household income between 100% and 400% above the federal poverty level (which currently works



tax aspects of the health care reform act

out to be between about \$22,000 and \$88,000 for a family of four) who are not eligible for Medicaid, employer-sponsored insurance, or certain other coverage.

The tax credit is effectively a subsidy only available for policies issued through a state insurance exchange and generally to be paid directly to the insurance provider. The amount of the credit depends on income level and the percent of income paid for premiums.

Employer Responsibility to Provide Insurance. Beginning in 2014, businesses with 50 or more full-time employees are required to provide adequate health insurance coverage. Insurance is not considered "adequate" if it does not provide certain minimum benefits, is unaffordable to the employees, or pays for less than 60% of employee health costs.

For each year adequate coverage is not provided, the employer must pay a penalty of \$2,000 for each full-time employee beyond a total of 30. An employee working 30 or more hours a week is considered "full-time"; part-time employees are counted on a prorated basis based on hours worked. To trigger the penalty, at least one full-time employee must purchase health insurance through a state exchange and be entitled to the tax credit described above.

A separate penalty of \$3,000 per employee receiving the benefit of a premium tax credit also may apply in certain cases.

For tax years beginning in 2010, a tax credit is available to help small businesses purchase coverage for employees. Employers with 10 or fewer full-time employees (with average wages of less than \$25,000 per year) may claim a tax credit of 35% based on employer-paid premiums. Partial tax credits are available for employers with 11 to 25 employees and average wages of up to \$50,000. Beginning in 2014, the tax credit increases to 50% of premiums an employer pays for coverage through an applicable state insurance exchange.

This tax credit generally is not available with respect to coverage of self-employed individuals, including partners and sole proprietors, 2% shareholders of S corporations, and 5% owners of the employer. Tax-exempt small businesses meeting the requirements may claim a reduced tax credit of 25% (35% after 2013).

Taxes Generally Related To Health Care

A significant portion of the Act is financed through revenue raisers relating to various other aspects of the health care system.

Individuals. Beginning January 1, 2013, the Medicare tax rate payable by individuals increases by 0.9% (to 2.35%) for wages over \$200,000 for single taxpayers (\$250,000 for spouses filing jointly). The employer's share of the Medicare tax remains unchanged at 1.45%. The rate increase also applies to the self-employed.

Taxpayers also are required to make Medicare contributions at the 3.8% rate on their net investment income or, if less, the excess of income over certain amounts. The income levels are \$200,000 of adjusted gross income (reduced by certain foreign-earned net income) for single returns and \$250,000 for joint returns. For this purpose,



tax aspects of the health care reform act

net investment income includes interest, dividends, rental income, royalties, passive activity income, and net gain on sale of property not held in a trade or business, less applicable expenses.

In addition, the threshold for deducting medical expenses increases to 10% of adjusted gross income (from 7.5%) effective beginning in 2013 (2017 for taxpayers age 65 and over and their spouses). This change does not apply for alternative minimum tax purposes.

Employers. Effective for tax years beginning after December 31, 2012, employers are no longer able to deduct the cost of providing Medicare Part D prescription drug coverage to retirees, to the extent of the tax-free federal government subsidy the employer receives for the coverage.

Employers are required to report the value of health care benefits provided to employees, beginning with W-2s issued for 2011.

Benefit Plans. After 2010, costs for over-the-counter medications (unless prescribed by a physician) other than insulin may not be reimbursed through health care flexible spending accounts (FSAs) or health reimbursement accounts (HRAs) or reimbursed on a tax-free basis through health savings accounts (HSAs) or Archer medical savings accounts (Archer MSAs).

Employee contributions to health care FSAs are capped at \$2,500 per year beginning in 2013.

For tax years beginning after December 31, 2010, the following penalties increase to 20%:

- Nonqualifying distributions from HSAs;
- Withdrawals before age 65 from HSAs; and
- Archer MSA withdrawals other than for qualified medical expenses.

In a departure, a new employee benefit cafeteria plan is available to businesses with 100 or fewer employees for tax years beginning after 2010. The "simple cafeteria plan" generally is not subject to the nondiscrimination requirements applicable to cafeteria plans and for certain qualified benefits, such as group term life insurance, self-insured medical reimbursement plans, and dependent care assistance programs. Among other requirements, the employer must have 100 or fewer employees and the plan contribution rate (but not the dollar amount) must be the same for all employees.

Health Insurance Providers

"Cadillac" Plans. Starting in 2018, insurance providers are subject to a 40% tax on health insurance plan annual premiums of more than \$10,200 for single coverage (\$27,500 for families), excluding stand-alone dental and vision plans.



tax aspects of the health care reform act

The threshold amounts are higher for retirees at least 55 years of age and for employees in certain high-risk professions, such as police officers, firefighters, and paramedics, but also including workers in the mining, fishing, and agriculture (other than food-processing) industries.

Insurance companies are liable for the tax relating to high-cost coverage under a group plan that provides health insurance coverage. However, the tax is applicable to employers if the coverage is provided through HSA or Archer MSA contributions, as well as to the self-employed, if provided under a plan that qualifies for tax deduction.

Executive Compensation. Health insurance providers may not deduct more than \$500,000 in annual compensation (including commissions and performance-based pay) for any officer, employee, director, or other service provider. This is generally effective for all insurers for tax years beginning after December 1, 2009, but, beginning in 2013, is only applicable to insurers earning more than 25% of their premiums from policies meeting minimum requirements under the Act.

Excise Tax. Beginning in 2014, health insurance providers as a whole are subject to an \$8 billion annual flat fee (increasing to \$14.3 billion in 2018 and thereafter), allocable among the insurance providers based on the market share of net premiums.

Health Care-Related Industries

Pharmaceuticals. Manufacturers and importers of branded prescription drugs are required to pay a total annual fee of \$2.5 billion in 2011 (increasing to \$4.1 billion in 2018, then dropping to \$2.8 billion thereafter), generally to be allocated among them based on market share.

Medical Devices. Manufacturers and importers of medical devices pay a tax of 2.3% for their sales after December 31, 2012. The tax does not apply to eyeglasses, contact lenses, hearing aids, and other devices generally purchased at retail for individual use.

Tanning Services. A 10% tax applies to indoor tanning services provided after June 30, 2010. It is payable by the consumer; however, the service provider is liable if it does not collect the tax. The tax does not apply to certain therapies performed by licensed medical professionals.

Tax-Exempt Hospitals. For tax years beginning after March 23, 2010, a Section 501(c)(3) organization operating at least one hospital facility may lose its federal tax-exempt status unless it meets certain new requirements relating to financial assistance policies, limits on charges, and billing and collections practices. In addition, if such organizations do not satisfy new community health needs assessment rules after March 23, 2010, they are subject to an excise tax of \$50,000 and, for tax years beginning after March 23, 2012, loss of tax exemption.

General Revenue Raisers

The Act also contains provisions unrelated to reforming the health care system (other than paying for it).



tax aspects of the health care reform act

Economic Substance Doctrine. The revenue raiser with perhaps the broadest reach beyond health care-related fields may be the inclusion of the "economic substance" judicial doctrine into the Internal Revenue Code (IRC).

Under this doctrine, tax benefits may be denied if a transaction lacks "economic substance" independent of tax considerations. Courts have applied this doctrine in various and divergent ways.

Effective for transactions entered into after March 30, 2010, a transaction has economic substance only if, disregarding federal income tax consequences, (1) the transaction changes the taxpayer's economic position in a meaningful way, and (2) the taxpayer has a substantial purpose for entering into the transaction.

Certain transactions are not subject to this rule, including the choice between funding a business through debt or equity or entering into a tax-deferred corporate reorganization.

Importantly, a 40% accuracy-related penalty is imposed on any underpayment of income tax relating to the disallowance of tax benefits as a result of the economic substance doctrine. This penalty is reduced to 20% if the taxpayer discloses the relevant facts on its income tax return. However, this is essentially a strict liability penalty, as there is no abatement for reasonable cause or for reliance on a legal opinion or other expert analysis.

The economic substance doctrine has been codified ostensibly to foster its application in a more uniform way. However, adding the doctrine to the IRC provides an opportunity to include the strict penalty and disclosure requirements that were not part of the rule as developed through the courts.

Information Reporting. After December 31, 2011, businesses are required to report to the IRS payments of \$600 or more to any corporation for property or services.

The Act and interpretive legislative reports consist of thousands of pages of minutiae. Please contact us if you have any questions or concerns regarding how the Act may apply to your circumstances.