

Health Care Reform Act

March 30, 2010

Special Report

HIGHLIGHTS

- Individual Responsibility Requirement
- No Universal Employer Mandate
- Small Business Tax Credit
- Additional Medicare Tax On Higher-Income Individuals
- Excise Tax On High Dollar Plans
- Market Sector Fees
- Codification Of Economic Substance Doctrine
- And More

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Congress Completes Overhaul Of Health Care Law; Makes Many Tax Changes

Passage of the Health Care and Education Reconciliation Act of 2010 (H.R. 4872) (Reconciliation Act) by Congress, followed by its signing by President Obama on March 30, 2010, completes a massive overhaul of the nation's health insurance and health delivery systems. The Reconciliation Act amends the Patient Protection and Affordable Care Act of 2010 (P.L. 111-148), which President Obama signed on March 23. Combined, the two new laws include more than \$400 billion in revenue raisers and new taxes on employers and individuals.

IMPACT. *President Obama's signature on the Reconciliation Act signals an end to the legislative process of health care reform and sets in motion the regulatory process as the IRS and many other federal agencies gear up to implement health care reform. The IRS is responsible for overseeing a significant part of health care reform, such as the administration of additional taxes and penalties on individuals and employers, determinations of various exemptions from those taxes, and oversight of new information reporting requirements. IRS Commissioner Douglas Shulman has said that one of the agency's first priorities will be guidance on the new small business tax credit for health insurance coverage.*

IMPACT. *The health care reform package (the Patient Protection Act as amended by the Reconciliation Act) does not mandate employer-provided coverage but it includes "play or pay language." The health care reform package also imposes a penalty on nonexempt individuals who*

fail to carry minimum essential coverage. On the revenue side, the health care package includes an additional Medicare tax on wages and self-employment income of higher income taxpayers, a new Medicare contribution tax on net investment income, and a delayed excise tax on high-dollar insurance plans, among its \$437 billion in new taxes, fees and penalties.

IMMEDIATE CHANGES

Many of the key provisions in the health care package take effect in 2010:

- Small business tax credit;
- Temporary high-risk pool for individuals who are uninsured because of a pre-existing condition;
- Temporary reinsurance program for early retirees;
- No discrimination against children with pre-existing conditions;
- No lifetime limits on coverage;
- Coverage for young persons until age 26 through parents' insurance; and
- A \$250 rebate to Medicare beneficiaries who are affected by the "donut hole."

CORE CONCEPTS

The Patient Protection Act, as amended by the Reconciliation Act, will fundamentally alter the health care landscape for individuals and employers. All individuals not covered by Medicare or Medicaid will be required to obtain health care coverage or pay a penalty unless they are exempt from the individual responsibility mandate. Employer-provided

coverage will generally satisfy the universal coverage requirement. Lower-income individuals, as well as some middle-income families, may qualify for a premium assistance tax credit, cost-sharing, or a voucher to help pay for health insurance. The health care reform package does not include a public option but provides for state insurance exchanges where individuals can shop for coverage.

COMMENT. *Individuals who currently have coverage and wish to retain that coverage can do so under a “grandfather” provision in the health care package and the coverage will be deemed to meet the individual’s responsibility to have health coverage. A similar grandfather provision applies to employers that currently offer coverage*

COMMENT. *The state insurance exchanges will offer tiered levels of coverage.*

INDIVIDUALS

Starting in 2014, the health care reform package (the Patient Protection Act as amended by the Reconciliation Act) requires most individuals not eligible for Medicaid, Medicare, other government-sponsored coverage or otherwise exempt from the universal coverage requirement to maintain minimum essential coverage. Individuals who fail to maintain minimum essential coverage will be liable for a penalty. The health care package uses a formula to calculate the penalty taking into account the taxpayer’s household income and a flat dollar amount.

The monthly penalty with respect to an adult individual who fails to carry mini-

um essential coverage is equal to 1/12 of the greater of the:

- Flat dollar amount, or
- Applicable percentage of income.

The flat dollar amount starts at \$95 in 2014, rises to \$325 in 2015 and increases to \$695 in 2016. For calendar years after 2016, the flat dollar amount is indexed for inflation.

“On the revenue side, the health care package includes an additional Medicare tax on wages and self-employment income of higher income taxpayers, a new Medicare contribution tax on net investment income, and a delayed excise tax on high-dollar insurance plans, among its \$437 billion in new taxes, fees and penalties.”

Further, a family’s total penalty generally cannot exceed 300 percent of the per adult flat dollar penalty (for example, \$285 for 2014, rising to \$2,085 by 2016) or the national average annual premium for the “bronze” level of coverage through the insurance exchange.

Additionally, the final health-care package sets the percentage of household income that is the alternative to the flat dollar annual penalty at one percent for 2014; two percent for 2015; and 2.5 percent for 2016 and subsequent years.

EXAMPLE. *Abby, a 34-year old single, does not have minimum essential coverage for all 12 months of 2016 and is not exempt from having minimum essential coverage. Abby would be liable for a penalty the greater of: \$695 or 2.5 percent of her modified adjusted gross income.*

COMMENT. *For individuals under the age of 18, the applicable flat dollar per individual penalty will be one-half of the above amounts.*

CAUTION. *Married couples who file a joint return are jointly and severally liable for any penalty.*

Individuals whose contribution toward employer-sponsored coverage or “bronze” level coverage through the insurance exchange would exceed 8 percent of household income are exempt from the penalty. Individuals with incomes below the federal income tax filing threshold are also exempt.

COMMENT. *The health care package also exempts religious objectors, undocumented aliens, incarcerated individuals, qualified members of Native American tribes, and certain hardship cases.*

COVERAGE SUBSIDIES

The health care reform package provides a refundable premium assistance tax credit and reduced cost sharing to qualified individuals, on a sliding scale, to help make coverage more affordable, starting in 2014. The premium assistance tax credit is designed to guarantee that qualified individuals would not spend more than a specific percentage of their incomes on health insurance premiums. Generally, these are individuals who cannot afford minimum essential coverage based on the

INDIVIDUAL RESPONSIBILITY

Year	Penalty	Percent of Income*
2014	\$95	1%
2015	\$325	2%
2016	\$695**	2.5%

* In lieu of the flat penalty if greater

** Indexed for inflation thereafter

relationship of their income to the federal poverty level (FPL).

COMMENT. *The premium assistance tax credit starts at 100 percent of (FPL) and climbs to 400 percent of FPL.*

COMMENT. *The IRS would be responsible for determining eligibility for the premium assistance tax credit. The health care package allows for the advanced payment of premium assistance tax credits. Further, premium assistance tax credits would be disregarded for federal or federally-assisted programs.*

An individual who has employer-provided coverage will not be eligible for a premium assistance tax credit after 2013 to obtain coverage in an insurance exchange unless the employer-provided coverage fails to meet certain coverage standards or if the individual's share of the premium would exceed a certain percentage of the individual's income. An employer-provided plan that provides less than 60 percent of the total allowed costs or when the employee's required contribution exceeds 9.5 percent of household income will not be deemed to provide minimum essential coverage.

COMMENT. *After 2014, the 9.5 percent limit is adjusted to reflect the excess of premium growth over income growth for the preceding calendar year. After 2018, an additional adjustment involving the CPI growth rate for the preceding calendar year may be required.*

LONG-TERM CARE

The health care reform package creates a national voluntary insurance program for purchasing community living assistance services and support. Premiums will be paid through payroll deductions if an individual's employer decides to participate in the program.

EARLY RETIREES

The health care reform package creates a temporary reinsurance program for employer-

sponsored early retiree coverage. Payments made under the reinsurance program for retirees would be excluded from gross income.

COMMENT. *Health services provided or purchased by the Indian Health Service would also be excluded from gross income.*

EMPLOYERS

The health care reform package does not require employers to provide health insurance coverage. However, "large" employers (generally employers with 50 or more full-time employees but with some exceptions) will be subject to "play or pay" rules after 2013. The health care reform package generally treats employees working 30 or more hours per week as full-time employees.

A nondeductible penalty will be assessed on a large employer that:

- (1) Fails to offer its full-time employees and their dependents the opportunity to enroll in minimum essential coverage under an employer-sponsored plan if at least one full-time employee is enrolled in an insurance exchange and receives a premium assistance tax credit or cost-sharing; or
- (2) Offers, for any month, its full-time employees and their dependents the opportunity to enroll in minimum essential coverage under an employer-sponsored plan and any full-time employee is enrolled in an insurance exchange and receives a premium assistance tax credit or cost-sharing.

In the case of (1) above, the penalty is equal to the product of the applicable payment amount which is 1/12 of \$2,000 for any month (\$166.67) and the number of full-time employees for the month.

In the case of (2) above, the penalty is equal to the product of the number of full-time employees receiving a premium assistance tax credit or cost-sharing for the purchase of health insurance through an insurance exchange for the month and an amount equal to 1/12 of \$3,000 for any month (\$250). However, the aggregate amount of the penalty on an employer for any month is limited to the product of the applicable payment amount (1/12 of \$2,000 per month) and the number of full-time employees during that month.

IMPACT. *The penalty would apply to employers with 50 or more workers but would subtract the first 30 workers from the payment calculation. Businesses with fewer than 50 employees would be exempt from any employer responsibility.*

EXAMPLE. *In 2014, ABC Co. has 101 full-time employees, does not offer its employees minimum essential coverage, and has at least one full-time employee enrolled in an insurance exchange who receives a premium assistance tax credit or cost-sharing. ABC Co. will be liable for a penalty.*

Free choice vouchers. Beginning in 2014, an employer that offers minimum essential coverage through an eligible employer-sponsored plan and pays any portion of the plan's costs is required to provide free choice vouchers to qualified employees. A qualified employee for

PREMIUM TAX CREDITS FOR AFFORDABILITY

Household income*	Initial premium percentage	Final premium percentage
Up to 133%	2.0	2.0
133% up to 150%	3.0	4.0
150% up to 200%	4.0	6.3
200% up to 250%	6.3	8.05
250% up to 300%	8.05	9.5
300% up to 400%	9.5	9.5 (and special indexing rules)

* Household income expressed as a percent of the federal poverty level

this purpose is an individual who does not participate in the employer's health insurance plan, whose household income does not exceed 400 percent of the FPL, and whose required contribution for employer-sponsored minimum essential coverage would exceed eight percent but not exceed 9.5 percent of household income if the individual participated in the employer-sponsored plan.

COMMENT. *Free choice vouchers are excluded from the individual's income to the extent they are used to obtain qualified health insurance coverage. Any excess amount would be included in the individual's income.*

COMMENT. *Individuals who receive free choice vouchers would be precluded from obtaining a premium assistance tax credit or cost-sharing to secure coverage in an insurance exchange.*

Reporting. Employers and other entities providing minimum essential coverage would be required to file information returns with the IRS identifying the individual, the coverage and the amount of premium, if any, paid by the individual. Penalties would be imposed for failure to file an information return.

SMALL BUSINESSES

Beginning in 2010, the health care reform package provides a temporary sliding-scale small employer tax credit to help offset the cost of employer-provided coverage. Generally, a qualified small employer is one with no more than 25 employees and average annual wages of no more than \$50,000. The qualified small employer must contribute at least one-half of the cost of health insurance premiums for coverage of its participating employees.

In 2010 through 2013, qualified small employers may qualify for a tax credit for up to 35 percent of their contribution toward the employee's health insurance premium. After 2013, small employers that purchase coverage through an insurance exchange may

qualify for a credit for two years of up to 50 percent of their contribution. Salary reduction contributions are not counted.

Small employers with 10 or fewer employees and average annual wages of less than \$25,000 would be eligible for the full credit. The credit is reduced for small employers with 11 to 25 employees and average annual wages of \$26,000 to \$50,000. The wage amounts are indexed for inflation.

COMMENT. *Qualified small tax-exempt employers would be eligible for a reduced credit.*

Cafeteria Plans. The health care reform package relaxes the cafeteria plan rules to encourage more small employers to offer tax-free benefits to employees, including those related to health insurance coverage. It does so by carving out a safe harbor from the nondiscrimination requirements for cafeteria plans for qualified small employers.

ADDITIONAL MEDICARE PAYROLL TAX

Starting in 2013, the health care reform package broadens the Medicare tax base for higher-income taxpayers by:

1. Imposing an additional Hospital Insurance (HI) tax rate of 0.9 percent on earned income in excess of \$200,000 for individuals and \$250,000 for married couples filing jointly; *and*
2. Imposing a 3.8 percent "unearned income Medicare contributions" tax on higher-income taxpayers.

The 3.8 percent unearned income Medicare contributions tax is imposed on the lesser of:

- (i) Net investment income or
- (ii) The excess of modified adjusted gross income (AGI) over the threshold amount (\$200,000 for single individuals or heads of households; \$250,000 for married couples filing a joint return and surviving spouses; and \$125,000 for married couples filing separate returns).

IMPACT. *When the 3.8 percent surtax is added to the 0.9 percent tax also imposed by the health care reform package on higher-income taxpayers, \$210.2 billion is estimated to be raised over the 2013 to 2019 period.*

IMPACT. *Neither the \$200,000 nor \$250,000 amounts are indexed for inflation.*

IMPACT. *Modified AGI is adjusted gross income increased by the amount excluded from income as foreign earned income less deductions attributable to such income.*

EXAMPLE. *Tom has modified AGI of \$220,000 and net investment income of \$40,000. The tax applies to the lesser of (i) net investment income (\$40,000) or (ii) modified AGI (\$220,000) over the threshold amount for a single person (\$200,000) or \$20,000. The tax is 3.8 percent of \$20,000 or \$760. The tax in this case is not applied to the entire \$40,000 of investment income.*

Net investment income includes interest, dividends, royalties, rents, gain from disposing of property from a passive activity, and income earned from a trade or business that is a passive activity. In determining net investment income, investment income is reduced by deductions properly allowable to that income.

Net investment income does not include distributions from qualified retirement plans, including pensions and certain retirement accounts. For example, income from individual retirement accounts (IRAs), 401(a) money purchase plans, 403(b) and 457(b) plans would be exempt.

Estates and trusts. Estates and trusts will also pay a 3.8 percent unearned income Medicare contribution tax on the lesser of (1) their undistributed net investment income for the tax year or (2) any excess of their adjusted gross income over the dollar amount at which the highest tax bracket for estates and trusts begins for the tax year (currently

at \$11,200, but subject to inflation adjustment each year). Charitable remainder and other tax-exempt trusts are excluded.

TAX ON HIGH-COST INSURANCE

Beginning in 2018, the health care reform package will impose a 40 percent nondeductible excise tax on insurance companies or plan administrators for any health insurance plan with an annual premium in excess of an inflation-adjusted \$10,200 for individuals and an inflation-adjusted \$27,500 for families. The

health care reform package provides higher premium levels for employees in certain high-risk professions: \$11,850 for individual coverage and \$30,950 for family coverage. Non-Medicare retirees age 55 and older are also eligible for the higher thresholds.

IMPACT. *Congress delayed application of the excise tax from 2013 until 2018 to give plans “time to implement and realize the cost savings of reform.” Because of this delay, however, the final health care reform package eliminates the three-year transition relief that had been available in the Patient Protection Act for coverage in 17 high-cost states.*

IMPACT. *An insurer would be free to pass along the excise tax to consumers in the form of higher premiums as an alternative to, or in combination with, finding cost-cutting opportunities.*

Cost of living adjustments. The threshold amounts for 2018 are indexed using CPI-U. For 2019 only, an additional one percent is added to the cost of living adjustment. Thereafter, the amounts will be adjusted only using the base CPI-U.

The health care reform package excludes completely the value of stand-alone dental and vision plan coverage from determining the excise tax thresholds. Fixed indemnity health coverage purchased by the employee with after-tax dollars is also excluded. The health care reform package also provides adjustments to the thresholds to account for plans that carry a higher premium cost because of the participants' age or gender.

EXAMPLE. *Dan, age 40, elects family coverage under an employer-provided fully-insured health care policy covering major medical with a value of \$37,000. The amount subject to the excise tax would be \$9,500 (\$37,000 - \$27,500 (the threshold for family coverage)). Dan's employer would report \$9,500 as taxable to the insurer. The insurer calculates and pays the tax to the IRS.*

PLANNING NOTE. *Starting in 2011, to increase employee awareness of the premium costs, employers will be required to disclose the value of employer-provided health insurance to employees annually on Form W-2.*

MARKET SECTOR FEES

The health care reform package imposes annual nondeductible fees on pharmaceutical manufacturers and importers and health insurance providers. The annual fees would be allocated across industry sectors according to market share. The annual fee for the pharmaceutical manufacturing and importing industry is \$2.5 billion for 2011; \$3 billion for 2012 to 2016; \$4 billion for 2017; \$4.1 billion for 2018; \$2.8 billion for 2019 and subsequent years. The annual fee for the health care provider industry is \$8 billion for 2014; \$11.5 billion for 2015 and 2016; \$13.5 billion for 2017; \$14.3 billion for 2018 and subsequent years.

COMMENT. *Certain small pharmaceutical manufacturers and importers and health insurance providers, including nonprofit insurance providers service lower income and other targeted groups, are exempt from the fees.*

COMMENT. *The health care reform package removes an annual fee that would have been imposed on medical device manufacturers. However, as a trade-off, the health care reform package adds an excise tax of 2.3 percent on medical device sales. Certain medical devices routinely purchased by consumers, such as eyeglasses and hearing aids, are exempt from the excise tax.*

FSAs AND HSAs

The health care reform package modifies the definitions of qualified medical expenses for health FSAs, HSAs, and HRAs to conform them to the definition used for the medical expense itemized deduction beginning in 2011. Thus, over-the-counter medicines are excluded unless prescribed by a health care professional. The health care package also

TIMELINE OF EFFECTIVE DATES

2010

- Smaller Employer Tax Credit
- Dependent Adult Child Coverage
- Indoor Tanning Tax
- Codified Economic Substance Doctrine

2011

- Only Dr. Prescribed Medicines Covered by FSAs/HSAs
- Employer W-2 on Value of Health Benefits

2013

- Medicare 0.9% Increase for \$200K/\$250K+ Wages
- 3.8% Tax on Net Investment Income of High Income Taxpayers
- 10% AGI Floor on Itemized Medical Expenses
- \$2,500 cap on FSAs

2014

- Individual Shared Responsibility Penalty
- Coverage Subsidies
- Large Employer Mandate – “Play-or-Pay”

2018

- 40% excise tax on high-cost insurance

caps health FSA contributions at \$2,500 per year after 2012, which is indexed annually for inflation after 2013.

The health care reform package also increases the additional tax on nonqualified distributions from HSAs from 10 percent to 20 percent and from Archer MSAs from 15 to 20 percent beginning in 2011.

COMMENT. *To prevent an end-run around the new FSA restrictions using cafeteria plan rules, the health care reform package provides that, if a benefit is available under a cafeteria plan through employer provided contributions to a health FSA, the benefit will not be treated as a qualified benefit unless the cafeteria plan provides that an employee may not elect for any taxable year to have salary reduction contributions in excess of \$2,500 made to the arrangement.*

MEDICAL EXPENSE DEDUCTION

The health care reform package raises the threshold for the itemized medical expense deduction from 7.5 percent of adjusted gross income (AGI) to 10 percent of AGI for regular income tax purposes effective for tax years beginning after December 31, 2012. However, individuals age 65 and older (and their spouses) will be temporarily exempt from the increase. The exemption for seniors applies to tax years beginning after December 31, 2012 and before January 1, 2017.

IMPACT. *The health care reform package makes no adjustment to the allowable medical expense deduction for purposes of computing alternative minimum tax (AMT) liability. For now, the AGI floor for AMT purposes remains at 10 percent.*

ADULT CHILDREN COVERAGE

The health care reform package extends the employer-provided health coverage gross income exclusion to coverage for adult chil-

dren under age 27 as of the end of the tax year. Self-employed individuals are allowed a deduction for the premiums paid on such dependent coverage.

COMMENT. *A separate, non-tax provision in the new law requires plans to cover dependent children up to age 26.*

ADOPTIONS

The health care reform package makes the adoption credit refundable. It also raises the dollar limitation for the credit to \$13,170 and extends the credit through 2011. The health care package also enhances the incentives for adopting children with special needs and the adoption assistance exclusion.

TAX-EXEMPT HOSPITALS

The health care reform package requires Code Sec. 501(c)(3) hospitals to conduct periodic community health needs assessments and adopt written financial assistance policies. Individuals who qualify for financial assistance would be billed at the same rates as insured individuals. The bill would also add some consumer protection provisions to debt collection activities by nonprofit hospitals.

COMMENT. *The IRS would be required to review a nonprofit hospital's community benefit activities at least once every three years.*

HEALTH INSURANCE EXECUTIVE PAY

The health care reform package modifies Code Sec. 162(m) as it applies to compensation paid by health insurance providers to high-level executives. If at least 25 percent of the insurer's premium income does not meet minimum essential coverage requirements under the Act, no Code Sec. 162(m) deduction would be allowed to the extent the compensation exceeds \$500,000, with a special provision for deferred compensation.

INDOOR TANNING TAX

The health care reform package imposes a tax of 10 percent on qualified indoor tanning services effective for services provided on or after July 1, 2010.

NEW THERAPIES TAX CREDIT

On the positive side of the ledger for the health industry, the health care reform package creates a new two-year temporary tax credit to encourage investments in new health care therapies for tax years beginning in 2009 and 2010.

MEDICARE PART D

The health care reform package eliminates the deduction for the subsidy for employers that maintain prescription drug coverage for retirees who are eligible for Medicare Part D, starting in 2013.

OTHER REVENUE RAISERS

In addition to health-care related taxes and fees, several other areas have been targeted to raise more revenue as an offset to the overall cost of the entire reform package. These additional provisions are estimated to raise \$28.1 billion over the 2010-2020 scoring period.

BIOFUEL CREDIT

The cellulosic biofuel credit was intended to reward taxpayers that use alternative fuels in industrial and other processes. The health care reform package targets what some lawmakers perceive as certain industries' abuse of the credit by denying the credit to a by-product known as "black liquor." The provision applies to fuels sold or used on or after January 1, 2010.

COMMENT. *This nonmedical revenue provision is a money maker, raising \$23.6 billion. However, both this provision and*

codification of the economic substance doctrine are used as the primary revenue raisers in the version of the Extenders bill the Senate passed on March 10, thus jeopardizing a quick resolution of that bill between House and Senate negotiators.

ECONOMIC SUBSTANCE DOCTRINE

The health care reform package codifies the economic substance doctrine. A transaction would have economic substance only if the taxpayer's economic position (other than its federal tax position) changed in a meaningful way and the taxpayer had a substantial purpose (other than a federal tax purpose) for engaging in the transaction. The provi-

sion applies to transactions entered into after date of enactment.

COMMENT. *Violations are subject to stiff, automatically-applied penalties of 20 or 40 percent, depending on the underlying transaction and level of disclosure. This no-fault penalty regime concerns many advisors, especially in connection with corporate and partnership tax planning strategies in which tax reduction has been an acceptable principal reason for structuring certain deals.*

CORPORATE ESTIMATED TAX PAYMENTS

The health care reform package increases the required corporate estimated tax pay-

ments factor for corporations with assets of at least \$1 billion for payments due in July, August, and September 2014 by 15.75 percentage points.

INFORMATION REPORTING

The health care reform package imposes new information reporting requirements. Generally, businesses that pay any amount greater than \$600 during the year to corporate and noncorporate providers of property and services will be required to file an information report with each provider and with the IRS.