

**New Healthcare Act** Time-released tax impact revealed.

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The debate over the future of the U.S. health insurance (and healthcare) industry ended last month with the passage of the **Patient Protection and Affordable Care Act (P.L. iii-148) and the Health Care and Education Reconciliation Act of 2010 (P.L. 111-152) [together the Healthcare Bill]**. Despite the lively debates and opinions from all sides, businesses and individuals are just now beginning to understand how the \$900 billion/2,400page bill will affect their industry, their healthcare and their personal and business tax obligations. Congress wisely staged these provisions over the next several years. These stages will front-load the tax collections and spread out mandates and other fiscal impacts in order to give time for the federal and state governments, health insurers and healthcare providers to adapt their current practices to conform to the Healthcare Bill's mandates. The Congressional Budget Office website contains interesting annual projected tax and budget impact: The Congressional Budget Office website contains interesting annual and tax and budget impact. Following is a summary of the major provisions for employer-provided health insurance and new taxes under the Healthcare Bill:

## **2010**

Despite widespread belief that health coverage is mandatory now, the mandate for health insurance coverage does not actually take effect until 2014. However, effective in 2010, as companies renew their existing health insurance policies, new policies must cover children with preexisting conditions. New policies cannot kick employees out of the plan if they become sick. The policies must cover preventive checkups without requiring employee co-pays. Lifetime limits on medical costs are no longer allowed. Businesses must provide the same coverage for all employees and cannot offer richer benefits to the executives or equity owners without doing the same for line employees. Small employers (fewer than 100 employees and average wages of less than \$25,000) can get a 2010 tax credit up to 35 percent for the cost of health insurance provided to employees. Businesses with up to 25 employees and average annual wages for each employee of up to \$50,000 can get a partial credit. These health insurance credits can offset an employer's regular tax or its alternative minimum tax (AMT) liability on its 2010 return.

## **Tax and Penalty Funding Sources**

The infamous \$2.7 billion "tanning salon" tax of 10 percent becomes effective July 1, 2010 (in lieu of a proposed cosmetic surgery tax). Spray on tanning services are not subject to the new tax. Another penalty funding source is a potential 20 percent to 40 percent penalty associated with transactions that do not meet the newly codified and far-reaching, "Economic Substance" test in I.R.C. § 7701(0). I.R.C. § 7701(0)(5)(C) provides "The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted." However, once it is determined the doctrine applies, subsection (o)(1) provides a conjunctive test.

That is, a transaction will have economic substance only if "(A)The transaction changes in a meaningful way (*apart from Federal income tax effects*) the taxpayer's economic position and (B)The taxpayer has a **substantial** purpose (*apart from Federal income tax effects*) for entering into such transaction." According to the committee report, the subsection provides a uniform definition, but is not intended to constrain the courts in applying the doctrine. The committee report reiterates the support for transactions with longstanding acceptance, even though the decisions about these transactions are based on tax savings. These transactions include (quoting from the committee report):

- The choice between capitalizing a business enterprise with debt or equity;
- A U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment;
- The choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C; and
- The choice to utilize a related-party entity in a transaction, provided that the arm's length standard of section 482 and other applicable concepts are satisfied.

Subsection (o) allows a taxpayer to rely on reasons other than profit potential to prove economic substance. However, if the taxpayer relies on profit, then the present value of the reasonably expected pretax profit from the transaction must be *substantial* when compared with the present value of the expected net tax benefits. *See* I.R.C. § 7701(0)(2)(A). And, these benefits now include state tax effects and financial statement effects if these effects *relate to or originate with a federal tax decrease*. The Healthcare Bill added a new *strict liability* penalty for an underpayment because of a transaction lacking economic substance under I.R.C. § 7701(0). *See* I.R.C. §§ 6662(b)(6) and 6664(d). The penalty rate is 20 percent, which increases to 40 percent without adequate disclosure. *See* I.R.C. § 6662(i).

## 2011

The Healthcare Bill eliminates the current 28 percent reimbursement of over-the-counter medications from Health Savings Accounts (HSA), Flexible Savings Account (FSA) and Medical Savings Accounts (MSA). Employers must begin reporting the aggregate cost of applicable employer-sponsored coverage on Form W-2. This is for information reporting only; the cost of the coverage is not included in gross/taxable income.

Taxpayers participating in HSAs and MSAs must pay a 20 percent (currently 10% and 15%) tax on amounts not used for qualified health expenses. Small businesses will be able to offer a tax-free SIMPLE (Savings Incentive Match Plan for Employees) employee benefit Cafeteria Plans for employees. Brand-name drug manufacturers and importers will pay an added \$2.5 billion in annual taxes. Small employers can offer long-term-care plans with automatic enrollment and payroll deductions unless the employees opt out.

## 2012

IRC § 6041(a) includes more 1099 reporting of business-to-business payments. Payors (including all corporations) will have to report all payments of \$600 or more for ***amounts paid in consideration for property and other gross proceeds, fixed or determinable gains, profits and income.***

## 2013

Schedule A deductibility "floor" on medical expense deductions increases from current 7.5 percent to 10 percent of adjusted gross income (AGI). Taxpayers over 65 (coincidentally the average age of a member of Congress) will keep the 7.5 percent limit until 2016. "Medical Devices," including X-Ray machines, MRIs, heart defibrillators and various other equipment and supplies, are subject to a 2.3 percent excise tax. Annual FSA amount limited to \$2,500 a year.

### **Various additional Social Security and income taxes will affect individuals in 2013** **Medicare Tax — Employee**

New paragraph I.R.C. § 3101(b)(2) provides for an added Medicare tax on wages equal to 0.9 percent on wages exceeding \$250,000 on joint returns, \$125,000 on married filing separate returns or \$200,000 otherwise. The healthcare act added subsection (f) to I.R.C. § 3102 - the section imposing a duty on employers to withhold FICA and Medicare tax. However, the Healthcare Bill did not amend I.R.C. § 3111 — the section imposing FICA and Medicare tax on employers. Therefore, this added Medicare tax affects only employees, *not* employers.

New subsection I.R.C. § 3102(f) provides,

- The employer must withhold the 0.9 percent only from wages it pays exceeding \$200,000. *See* new paragraph I.R.C. § 3102(f)(1).
- The employer may ignore wages received by the employee's spouse. *See* new paragraph I.R.C. § 3102(f)(1).
- If the employer does not withhold enough tax to meet the employee's liability, the employee must pay it. *See* new paragraph I.R.C. § 3102(f)(2).

New subsection I.R.C. § 6654(m) provides this is a Chapter 2 tax. I.R.C. § 6654(f)(2) provides that estimated tax payments include Chapter 2 taxes.

### **Medicare Tax — Self-Employed**

New paragraph I.R.C. § 1401(b)(2) provides for an added Medicare tax on individuals equal to 0.9 percent on self-employment income exceeding \$250,000 on joint returns, \$125,000 on married filing separate returns or \$200,000 otherwise. There is a cross-reference in new subparagraph I.R.C. § 1401(b)(2)(B) intended to lower these thresholds for wages counted for I.R.C. § 3101(b)(2). However, it currently refers to I.R.C. § 3121(b)(2) — an incorrect cross-reference. Like the Medicare tax on employees above, the self-employed person pays only the "employee" portion, not the "employer" portion. Therefore, amended paragraph I.R.C. § 164(f)(1) precludes a deduction for any of the 0.9 percent. I.R.C. § 1401 is a Chapter 2 tax subject to estimated tax payment inclusion.

### *Income Tax*

New I.R.C. § 1411 provides for an added tax equal to 3.8 percent on the *lesser of*

- the net investment income *or*
- the excess of the taxpayer's modified AGI over certain thresholds.

The thresholds are \$250,000 on joint returns, \$125,000 on separate returns and \$200,000 otherwise. This is a tax on unearned income so there is no withholding requirement. New I.R.C. § 1411 is in new Chapter 2A subject to estimated tax inclusion.

## **2014**

Employer and individual mandate to buy health insurance begins. Both self-employed and W-2 employees must buy individual policies if their employer does not provide coverage. For low-income individuals, a premium assistance credit becomes available in 2014.

Businesses with 50 or more employees must provide them with health coverage or pay a \$2,000 penalty per employee (over a 30-employee threshold). Penalties for noncompliance with the individual mandate range from the greater of: i) \$95 (2014) \$325 (2015) or \$695 (2016 and after) or ii) 1.0 percent (2014) 2.0 percent (2015) or 2.5 percent (2016 and after) of the taxpayer's household income over the threshold amount for filing a tax return for the taxpayer's filing status (Sec. 6012(a)(1)). For years after 2016, the penalties are indexed for inflation. The applicable tax credit percentage for the small business tax credit (discussed above) is increased from 35 percent to 50 percent of premiums paid to subsidize the purchase of employee policies. Insurers (including businesses that self-insure) will be required to start reporting certain health insurance coverage information to both the insured individuals and to the IRS.

## **2018**

In the spirit of "no good deed goes unpunished," a 40-percent excise tax applies to employers who offer "Cadillac Insurance Plans." These plans include health insurance policies with an annual cost of more than the specified threshold amount for the year multiplied by the health cost adjustment percentage (as determined for the year) and increased by the age and gender adjusted excess premium amount (as determined for the year). The threshold amount for 2018 is \$10,200 for an individual plan or \$27,500 for family coverage.

## **Conclusion**

With the continuing debate over the overall Healthcare Bill and specific provisions within the Bill, we should expect to see some of these provisions modified before they take effect as the social, economic and industry impact is more fully analyzed.

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