

# Titus Tax Alert

## Historic Health Care Law: *Significant Financial and Tax Implications for Business*

April 2010

Known as the Patient Protection and Affordable Care Act, the new far-reaching health care legislation recently signed into law by President Obama is expected to affect nearly every American in some manner. The legislation will have a significant impact on the business community including tax implications which are outlined later in this document.

The Congressional Budget Office estimates the cost of the new health care law to be \$940 billion over 10 years, but also estimates that it will reduce the federal deficit by \$130 billion in the next decade, and then by \$1.2 trillion during the following 10 years. It is considered by many to be the most sweeping social reform since Medicare was enacted in 1965.

The significant impact of health care costs on the U.S. economy is one area upon which Republicans and Democrats have found common ground. Congress estimates that in 2009 Americans spent approximately \$2.5 trillion on health care, or \$8,093 per person. This comes to 17.3 percent of GDP, which is nearly twice the average of other developed nations. Based on these figures, the new health care reform legislation will alter one-sixth of the U.S. economy. But in spite of the enormity of health care issues in the United States, President Obama and Congressional supporters still must sell the changes to a somewhat skeptical American public. As the implementation process begins and more light is shed on the underlying details of the legislation, it remains to be seen how the general public, industry participants and voters will react to the fine print.

### **Funding the Measure**

The overhauling legislation will be largely funded by:

- The imposition of new taxes on earned and net investment income of high earners;
- Cuts in Medicaid: People who make 133 percent of the federal poverty level (currently \$29,327 for a family of four) would be eligible for Medicaid, which was increased from 100 percent of the federal poverty level under current law. Also, a new amendment in the reconciliation bill eliminated the special funding for Nebraska's Medicaid program that was included in the original Senate bill and would have given Nebraska 100 percent federal financing for newly eligible Medicaid recipients in perpetuity. A different deal, worth up to \$300 million, that

was negotiated by Democratic Senator Mary Landrieu for Louisiana remains intact;

- The curtailment of tax breaks for out-of-pocket medical deductions; and
- The imposition of fees on a broad range of industry participants, from insurance companies to tanning salons (e.g., insurance companies would be denied deductions if they pay their executives in excess of \$500,000 and, effective July 1, 2010, a 10 percent excise tax is imposed on consumers who purchase indoor tanning services).

### **Estimated Revenue Effects**

An analysis by the congressional Joint Committee on Taxation indicates that the bill will generate \$409.2 billion in additional taxes by 2019. Also, according to the Congressional Budget Office, the new law is projected to result in the imposition of \$65 billion in additional penalties on individuals and businesses who fail to meet the mandates to buy insurance. Notably, most of the coverage and subsidy aspects of the new law will not come into effect until 2014, while the increased taxes and fees will become effective in years prior thereto. Also important is the IRS' assessment of the administrative impact of the myriad changes to the tax code - the Service estimates it will need an additional \$10 billion and 17,000 new employees to enforce the new tax provisions that accompany the rules.

### **Key Tax and Penalty Provisions:**

- Medicare Tax Changes. Most of the revenue needed to fund the cost of the new legislation will come from higher Medicare taxes. The legislation includes a Medicare bombshell, of sorts. Prior to the enactment of this legislation, the Medicare tax was limited to 2.9 percent of the earned income of a U.S. taxpayer. The new rules impose an additional Medicare tax of 0.9 percent on *earned* income above \$200,000 (individuals) or \$250,000 (filing jointly). Also, for the first time the legislation would apply a 3.8 percent "Unearned Income Medicare Contribution" tax on net *investment* income - specifically interest, dividends, royalties, rents, gross income from a trade or business involving passive activities and net gain from the disposition of capital property (i.e., other than property held in a trade or business) - for taxpayers with Adjusted Gross Income above those same thresholds. Net investment income is reduced by properly allocable deductions to such income. These new levies would take effect in 2013.
  - President Obama's current budget proposes to allow the current 15 percent tax rate on dividends and capital gains to increase to 20 percent in 2011 for individuals with the above income thresholds. In conjunction with the additional 3.8 percent Medicare tax, the new marginal tax rate on dividends and capital gains will be nearly 24 percent. Further, the top tax rate on interest and rental income will rise above 40 percent if other Obama tax increases are enacted.
- Small Business Tax Credit. Effective beginning for calendar year 2010 and extending only through 2011, certain small businesses with 10 or fewer employees and average wages of \$25,000 or less will be eligible for a tax credit up to 35

percent of premiums for the cost of providing employee health benefits. The credit phases out as the number of employees increases to 25 and average wages increase to \$50,000. The credit does not apply with respect to certain employees, such as business owners.

- Health Savings Accounts. Effective in 2011, the penalty tax for Health Savings Account (HSA) distributions *not* used for health care expenses doubles from 10 percent to 20 percent. This provision may discourage the use of HSAs for supplemental retirement savings.
- Archer Medical Savings Accounts. The legislation increases the additional tax for Archer MSA withdrawals from 15 percent to 20 percent. This provision is effective in 2011.
- Limits on Threshold for Claiming the Itemized Deduction for Medical Expenses. Starting in 2013, the 7.5 percent floor for deducting medical and dental expenses climbs to 10 percent (unless the taxpayer or their spouse is 65 or older, in which case it remains at 7.5 percent until 2016).
- Health Flexible Spending Accounts. Starting in 2013, Healthcare Flexible Spending Account (FSA) contributions are capped at \$2,500 per person per year. The funds in the account also would count toward the caps for purposes of the “Cadillac tax” imposed on high dollar insurance plans provided by employers (see next paragraph).
- High Cost Employer-Sponsored Health Coverage. This provision, coined the “Cadillac tax” during the Clinton administration, targets high dollar insurance plans provided by employers that are thought to be a luxury when compared to most insurance plans. Specifically, an excise tax of 40 percent is due on insurance companies and plan administrators for any health coverage plan with an annual premium that is above the threshold of \$10,200 for single coverage and \$27,500 for family coverage, and the tax applies to the amount of the premium in excess of the above dollar thresholds. Because the Congressional Joint Committee on taxation estimated that this tax ultimately will affect a broad array of taxpayers and not only so-called high-dollar insurance plans, the imposition of this tax is delayed until 2018.
- Executive Compensation Limits. This provision limits the deductibility of executive compensation for insurance providers if at least 25 percent of the insurance provider’s gross premium income is derived from health insurance plans that meet the minimum essential coverage requirements in the bill (“covered health insurance provider”). The deduction is limited to \$500,000 per taxable year and applies to all officers, employees, directors and other workers or service providers performing services for or on behalf of a covered health insurance provider. The provision is effective in 2013.
- Employer Reporting Requirements. Starting in 2011, employers will be required to report the value of health benefits provided by the employer for each employee’s health insurance coverage on the employee’s annual Form W2.
- Employer Penalties. Starting in 2014, businesses with more than 50 employees may either offer health benefits to all full time workers or pay a penalty of \$2,000 per employee as long as at least one full time employee receives a subsidy for coverage through new state-based purchasing pools called “Exchanges.” Stated

- differently, the \$2000-per-employee fee would be assessed on the company's entire work force less an allowance.
- Limitation on Treaty Benefits for Certain Deductible Payments. This provision prevents foreign multinationals that are incorporated in tax haven countries from avoiding tax on income earned in the United States. The provision is aimed at multinationals that route income through structures that allow a U.S. subsidiary to make a deductible payment to a country that has a tax treaty with the United States, and, thereafter the company repatriates the earnings in the tax-haven country after the deduction is taken.
  - Investment Credit for New Therapies. Effective for expenses paid or incurred after Dec. 31, 2008, in tax years beginning after that date, a two-year temporary credit would be created to encourage investments in new therapies to prevent, diagnose, and treat acute and chronic diseases. The provision establishes a 50 percent nonrefundable investment tax credit for qualified investments in qualifying therapeutic discovery projects. The provision allocates \$1 billion to the program during the two-year period 2009 through 2010. The Secretary, in consultation with the Secretary of the HHS, will award certifications for qualified investments. The credit is available only to companies having 250 or fewer employees. Taxpayers may elect to receive credits that have been allocated to them in the form of Treasury grants equal to 50 percent of the qualifying investment. Any such grant is not includible in the taxpayer's gross income.
  - Codification of the Economic Substance Doctrine and Increased Penalties. The reconciliation bill includes one more surprise – codification of the economic substance doctrine. Congress believes the economic substance doctrine, a judicial doctrine, has not been applied uniformly by the courts. The provision clarifies the manner in which the economic substance doctrine should be applied by the courts and would impose a penalty on understatements attributable to a transaction lacking economic substance. The provision is effective upon enactment. Concerns have been raised about the strict liability penalty standard and possibly increased penalties that would be imposed should a transaction fail the new economic substance test. The Act amends section 6664(c) of the Code to prohibit application of the “reasonable cause exception” to a substantial understatement penalty attributable to any transaction that fails the economic substance test. Therefore, not even a “more likely than not” (or greater standard) tax opinion will shield a taxpayer from penalties. Further, in an amendment to Section 6662 of the Code, the understatement penalty increases from 20 percent to 40 percent to the extent the understatement is attributable to any portion of a transaction that lacks economic substance and is not adequately disclosed in a return or statement attached to the return. For this purpose, non-disclosure cannot be cured by amendment or supplemental disclosure after notice of IRS examination of the relevant return (or other date as specified by the IRS). Finally, Section 6676 of the Code is amended to affirm that a claim for refund for an amount attributable to a transaction lacking economic substance will not be treated as having a reasonable basis and will therefore be subject to a 20 percent penalty on such amount.

**Comments:**

***Potential Negative Impact on Earnings Due to Loss of Deferred Tax Asset.*** In reporting the tax impact from the legislation, several companies, including AT&T, Caterpillar, AK Steel, 3M Co. and Deere and Co., have warned that they will see an immediate and material impact on their earnings as a result of the loss of deductions on tax-free subsidies they receive for providing retiree prescription-drug benefits. In 2003, companies began receiving a 28 percent federal subsidy tax-free, up to \$1,330 per retiree, for helping to pay for prescription-drug coverage. Prior to the recent law change, companies could deduct the subsidy from their taxable income, thereby receiving a second benefit from the payments. Although many of the health care legislative changes do not take effect until 2013 or thereafter, accounting rules may require companies to record the charge to earnings in the first quarter of 2010, the quarter and year of enactment, to reflect the loss of future tax deductions. In summary, companies will need to evaluate whether or not they must eliminate previously recorded deferred tax assets related to the loss of a stream of future tax deductions. If so, technically it would be a so-called “non-cash” charge, but ultimately affected companies will have higher tax liabilities due to the disallowance of the future deduction of subsidy amounts.

The subsidy has been a contentious topic since it was enacted in 2003 because it allowed companies to obtain the subsidy tax-free even when retirees paid some or all of the cost of their prescription drugs. Moreover, the same companies have been allowed to deduct the value of the subsidy, including amounts that are funded by its retirees. Under the new legislation, companies will continue to receive the tax-free subsidy based on their retirees’ contributions, but will not be able to deduct the value of the subsidy.

**Links:**

- To review the House Ways and Means Committee’s summary of the health care legislation, click [here](#).
- To see H.R. 4872, the text of the Reconciliation Act of 2010, click [here](#).
- To see the Joint Committee on Taxation’s Technical Explanation of the Revenue Provisions of the Reconciliation Act of 2010, as amended, in combination with the “Patient Protection and Affordable Care Act,” click [here](#).

For more information regarding this Tax Alert, please contact:

**Wendi Hangebrauck**  
**Titus - Chicago**  
**Tax Practice Director**  
**312.261.4400**  
[wendi.hangebrauck@titus-us.com](mailto:wendi.hangebrauck@titus-us.com)