



Health Care Reform Bill Becomes Law



President Obama signed into law a sweeping health care reform bill, that the House approved March 21. The law aims to extend health insurance to the more than 30 million Americans who are currently uninsured.

On March 21, the House passed the Patient Protection and Affordable Care Act (H.R. 3590) by a vote of 219-212. The bill was originally passed by the Senate on Dec. 24, 2009. The House also passed the Health Care and Education Affordability Reconciliation Act (H.R. 4872), which modifies key provisions of H.R. 3590, by a vote of 220-211. H.R. 4872 modifies H.R. 3590 by raising additional revenues from high-income households and reducing the impact that new excise taxes on high-cost health insurance policies will have on middle-class households. President Obama said the Senate will take up H.R. 4872 on March 23.

Together, the bills will significantly change the nation's health care system and will cost \$940B. To pay for these changes, the bills impose \$438B in new taxes and fees on insurers, businesses, and individuals. The remainder of the cost is paid for by cuts in Medicare funding. According to the Congressional Budget Office (CBO), the bills are expected to reduce federal deficits by \$143B over the next 10 years. The bills are also expected to expand health insurance coverage to 32 million individuals.

Tax Implications of Healthcare Legislation

The bills significantly increase taxes on individuals with higher incomes and those that have more costly health insurance plans. Taxes include:

- A new 3.8 percent "Medicare contribution" tax on unearned income beginning in 2013 for individuals earning more than \$200,000 per year (\$250,000 for joint filers). Unearned income is passive income that a taxpayer receives on investments and includes interest, dividends, royalty income, rental income, gross income from a trade or business involving passive activities, and net gain from the disposition of property (other than property held in a trade or business). The amount of income subject to the tax is adjusted for any properly allowable deductions related to that income. This provision significantly broadens the Medicare tax base. Importantly, the earning amounts are not indexed for inflation so the tax will apply to more taxpayers each year.
- A new 0.9 percent surtax on individuals earning more than \$200,000 per year (\$250,000 for joint filers) on their share of their Hospital Insurance (HI) payroll taxes. Like the Medicare contribution tax, the earnings amounts are not indexed. Together, these two provisions are expected to raise \$210B from 2013 until 2019.



- A new 40 percent nondeductible excise tax on individuals with plans costing more than \$8,500 (\$23,000 for families), which is adjusted for inflation. The threshold increases to \$9,850 (\$26,000 for families) for individuals with certain high-risk jobs or those older than 55 but not yet receiving Medicare. H.R. 4872 delays the start date of these taxes from 2013 until 2018. H.R. 4872 also raises the threshold for taxation to \$10,200 for individuals (\$27,500 for families). H.R. 4872 includes a less generous inflation index than H.R. 3590. Both bills index the thresholds to the rate of the consumer price index for all urban consumers plus 1 percentage point, but the indexing in H.R. 4872 doesn't start until 2019, making it more likely that health insurance plans would be affected by the tax if health costs rise faster than overall inflation. Under H.R. 4872, the threshold levels are adjusted for plans that are priced higher because of the age and gender of employees. The bill also excludes the value of dental and vision benefits from the thresholds.

The bills provide significant tax credits for some individuals and small businesses in order to achieve coverage, including:

- A new credit for small businesses with up to 25 employees and average annual wages of less than \$40,000. The credit, which is based on a sliding scale, will reimburse employers for up to 50 percent of the cost of providing insurance for their employees. For employers with fewer than 10 employees and average wages of less than \$20,000, a 100 percent credit is available.
- A new credit for businesses equal to 50 percent of investments made in 2009 and 2010 for new therapies to prevent, diagnose, and treat acute and chronic diseases. An eligible taxpayer is a small business which may not employ more than 250 employees at the time of the submission of the application. The qualified investment is the aggregate amount of the costs paid or incurred for expenses necessary for and directly related to the conduct of the qualified project. The higher credit rate will make this credit more lucrative than the traditional Research & Development (R&D) credit and even more valuable because it will permit inclusion of the cost of depreciable assets purchased for qualifying projects, subject to a reduction in the property's basis by the amount of the credit. Certain costs are excluded, such as interest expenses, facility maintenance expenses (mortgage or rent, insurance, utility, and maintenance personnel), service costs described under section 1.263A-1(e)(4), and payment to employees described under section 162(m)(3), which includes the CEO of the company or any employee the SEC has required to report his salary to shareholders based on the fact that he is among the four highest compensated officers.
- A new premium assistance tax credit for individuals earning less than 400 percent of the federal poverty level. The credit, which is based on a sliding scale, will reimburse individuals for the cost of higher insurance premiums. The scale starts at 2 percent of income for those at 133 percent of the poverty level and phases out at 9.8 percent of income for those at 300-400 percent of the poverty level. The bill also expands Medicaid to individuals below 133 percent of the poverty level.
- An increase in the tax credit for adoptions from \$10,000 to \$13,170. The bills make the adoption tax credit adjusted to inflation, refundable, and available through 2011.



In order to “bend the cost curve” of health insurance down by increasing the insurance pool, the bills impose penalties on individuals and employers for failing to obtain or provide coverage. These penalties also act as revenue raisers. The penalties include:

- Under H.R. 3590, a \$750 penalty on employers per full time worker not covered if the employer has 50 employees and at least one of their employees qualifies for a premium subsidy in the exchange. H.R 4872 increases the penalty to \$2,000 but exempts the first 30 employees from the penalty calculation.
- Under H.R. 3590, a penalty on individuals who fail to obtain coverage. The penalty is equal to the greater of a flat fee or a percentage of income. The flat fee is equal to \$95 in 2014, \$495 in 2015, and \$750 in 2016 and beyond. H.R. 4872 exempts individuals with incomes below the income tax filing threshold from the penalty and lowers the penalty amount to \$325 in 2015 and \$695 in 2016. The percentage of income is equal to 0.5 percent in 2014, 1 percent in 2015, and 2 percent in 2016 and beyond. H.R. 4872 increases those percentages to 1 percent in 2014, 2 percent in 2015, and 2.5 percent in 2016 and beyond. These changes provide relief to low-and middle-income individuals while increasing the burden on higher-income individuals.


The bills place new limitations on all individuals, including:

- A new \$2,500 limit on tax-free contributions to health care flexible spending accounts.
- An increase in the penalty for nonqualified withdrawals from health savings accounts to 20 percent.
- A new prohibition to use Flexible Spending Account funds to purchase nonprescription medications.
- An increase in the threshold for claiming deductions for medical expenses to 10 percent of a taxpayer’s adjusted gross income for those under 65, up from 7.5 percent.

The bills also include a number of new taxes and fees for businesses, including:

- A new 10 percent excise tax on indoor tanning services starting on July 1, 2010. This tax replaced a proposed tax on cosmetic surgery.
- A new excise tax on otherwise taxable medical device sales equal to 2.3 percent of the price of the device. A taxable medical device is any device defined in section 201(h) of the Federal Food, Drug, and Cosmetic Act and is intended for humans. This excise tax replaces an earlier proposed fee. Medical devices routinely purchased by consumers (as determined by the IRS) such as eyeglasses and hearing aids, are exempt from the tax.
- A new annual nondeductible fee on health insurance providers beginning in 2014. The fee would be allocated based on market share of net premiums written for U.S. health risks. The schedule for the flat fee would be: 2014, \$8 billion; 2015 and 2016, \$11.5 billion; 2017, \$13.5 billion; 2018, \$14.3 billion and indexed to medical inflation for later years. The fee would not apply to companies with net premiums written of \$25 million or less. Qualified nonprofit insurance providers serving lower-income and other targeted groups are exempt from the fees as are certain voluntary employee benefit associations.
- A new nondeductible annual fee on pharmaceutical manufacturers and importers of branded drugs beginning in 2011. The fee will be allocated across the industry according to market share. The schedule for the flat fee would be: 2011, \$2.5 billion; 2012 to 2016, \$3 billion; 2017, \$4 billion; 2018, \$4.1 billion; 2019 and later, \$2.8 billion. The fee would not apply to companies with sales of branded pharmaceuticals of \$5 million or less.
- A new requirement that 501(c)(3) hospitals conduct periodic community health needs assessments and adopt written financial assistance policies. Individuals that qualify for assistance will be billed at the same rates as insured individuals. The IRS will have to review these hospital's community benefit activities every three years.
- A modification of IRC section 162(m) as it applies to remuneration paid by health insurance providers to high-level executives. If at least 25 percent of the premium income to the insurer does not meet minimum essential coverage requirements under the bills, no 162(m) deduction would be allowed to the extent the remuneration exceeds \$500,000.





The bills also include revenue raisers that have been present in various pieces of tax legislation considered by the Congress, including:

- Codifying the common-law economic substance doctrine and imposing significant penalties on taxpayers entering into transactions that lack economic substance. Under the economic substance doctrine, courts must tax benefits to taxpayers that enter into transactions that lack economic substance. The bill resolves a split in the various Circuit Courts of Appeal by clarifying that a transaction will be treated as having economic substance only if it changes the taxpayer's economic position in a meaningful way and has a substantial non-tax business purpose for the transaction. Courts are required to see if the transactions entered into by the taxpayer have the potential for profit. This provision includes a new strict liability penalty under section 6662 for an understatement of income and section 6676 for a claim for an excessive refund or credit due to a transaction undertaken by the taxpayer that lacks economic substance. The penalty rate is 20 percent (40 percent for a failure to adequately disclose all relevant facts). It is not yet clear what form the disclosure must take. There is no reasonable cause exception for public companies and any corporation with gross receipts in excess of \$100M. The penalty provisions are expected to raise \$4.5B in revenue through a combination of assessment, disclosure and the avoidance of taxpayers entering into transactions that lack substance. It is unclear how the penalty will be applied in practice and how aggressive field agents will be in seeking to apply the penalty, however, it is clear that once an IRS makes a determination that a transaction lacks economic substance, they are required to assess the penalty.
- Disallowing the use of the cellulosic biofuel producer credit for paper manufacturers that use a fuel known as "black liquor" to power their plants. Black liquor is a byproduct of paper pulp that has been used as a fuel since the 1930. This provision is expected to raise \$23.6B.

Summary

The Patient Protection Act and the House Reconciliation Act will fundamentally alter the health care system for individuals and employers. The bills push the U.S. closer to universal coverage by requiring all individuals not covered by Medicaid or Medicare to obtain health care coverage or pay penalties. Employers electing not to offer qualifying coverage would be subject to penalties. Certain small businesses are exempted. In order to help individuals and small business pay for these new requirements, the bill offers tax credits to cover premiums. The costs of increased coverage will be paid for by a series of new taxes and fees on individuals and business. Higher income individuals will be subject to increased payroll taxes and new taxes on passive income. Individuals with expensive health care plans will be required to pay a significant excise tax. Businesses in various industries will be subject to fees. The bill also pays for its provisions by making cuts in Medicare and Medicaid funding to states. It appears that Congress will take up legislation to restore these cuts by enacting the so-called "doc-fixes" that were debated as part of the current bills. If it passes, the "doc fix" bill, which is expected to cost \$371B, will restore much of the lost funding in the form of payments to doctors that accept Medicare and Medicaid. Additional changes to the current bills are likely to be passed in the coming months.