



## Health Care Reform Triggers New Provisions, Taxes

Representing a sweeping overhaul of the U.S. health care system, the Patient Protection and Affordable Care Act was signed into law on March 23 followed by a companion reconciliation act. 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. The implications of this legislation are outlined below.

### Increased taxes for high income earners and costly plans

***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.

***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.

***New 40 percent nondeductible excise tax on individuals with plans costing more than \$10,200 (\$27,500 for families), which is adjusted for inflation.*** The threshold increases to \$11,850 for individuals (\$30,950 for families) with certain high-risk jobs or those older than 55 but not yet receiving Medicare. The start date of these taxes has been delayed to 2018. The new rules index the thresholds to the rate of the consumer price index for all urban consumers plus 1 percentage point, starting in 2019. 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.

### Tax credits for some individuals and small businesses

***New credit for small businesses with up to 25 employees and average annual wages of less than \$50,000.*** 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.

***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. The qualified investment is the aggregate amount 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.

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***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.

***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.

### Penalties on individuals and employers who fail to obtain or provide coverage

***A \$2,000 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.*** The penalty is called an “assessable payment” and has a complex set of rules regarding when it is assessed and how to calculate the payment.

***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, \$325 in 2015, \$695 in 2016, and \$750 in 2017 and beyond. The percentage of income is equal to 1 percent in 2014, 2 percent in 2015, and 2.5 percent in 2016 and beyond. The bill exempts individuals with incomes below the income tax filing threshold from the penalty.

### Limitations on individuals

- 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

### New taxes and fees for businesses

***New 10 percent excise tax on indoor tanning services starting on July 1, 2010.*** This tax replaced a proposed tax on cosmetic surgery.

***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.

***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.

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***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.

***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.

***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.

## Revenue raisers

***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, 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. For transactions that lack economic substance, the transaction becomes taxable with a penalty rate of 20 percent (40 percent for a failure to adequately disclose all relevant facts). There is no reasonable cause defense to this 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.

## Contact us

The Patient Protection and Affordable Care Act and the House Reconciliation Act will fundamentally alter the health care system for individuals and employers. If you have any further questions, please contact your tax advisor at Elliott Davis.

### Jason Sweatt

Tax Practice Chair

[jsweatt@elliottdavis.com](mailto:jsweatt@elliottdavis.com)

864.242.2602

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