Summary of Tax Provisions of 2010 Health Care Reform Legislation

For Clients and Friends of GSRP, LLP

On March 23rd, President Obama signed into law the Patient Protection and Affordable Care Act, followed shortly thereafter on March 30th by the Health Care and Education Reconciliation Act (collectively referred to herein as the "Act"). The Act unquestionably imposes significant changes in the provision of health care coverage in the U.S. by requiring individuals to maintain a certain level of health insurance coverage and requiring employers to offer qualifying coverage to their employees. Taxes, penalties, and tax credits are used as compliance incentives to implement these changes. The Act, however, goes beyond health care issues and introduces some quite burdensome recordkeeping and reporting requirements on business taxpayers. If you have not previously considered how these changes affect you, you absolutely must act now. This paper introduces the reader to the major tax provisions contained in the Act that affect individuals and businesses, and highlights some planning opportunities that exist in the wake of such provisions.

Tax Changes Affecting Individuals

Required Minimum Coverage

Beginning in 2014, the Act imposes a mandate on U.S. citizens and legal residents to obtain and maintain qualifying health coverage, or "minimum essential coverage." Minimum essential coverage includes the following types of coverage:

- Coverage under a government sponsored program (Medicare, Medicaid, CHIP, veterans health care program, TRICARE for Life, or health plan provided to Peace Corps volunteers);
- Eligible employer-sponsored plans (including grandfathered plans);
- Individual market plans; and
- Grandfathered plans (a group health plan or health insurance coverage that is in effect on March 23, 2010).

Individuals who fail to maintain minimum essential coverage will be required to pay a tax penalty equal to the greater of (a) $695 per year, up to a maximum of $2,085 per family, or (b) 2.5% of household income over a threshold amount of income required for income tax return filing. This penalty amount will be phased in beginning in 2014, with full implementation in 2016. After 2016, the penalty will increase annually by a cost-of-living adjustment. Exemptions to the minimum coverage requirement will be granted to certain religious and ethnic groups, and will also be granted for financial hardship, short periods (less than three months) in which an individual does not maintain qualifying health coverage, incarcerated individuals, and those for whom the cost of premiums would exceed 8% of household income. Additionally, individuals whose income is less than the amount required to require an income tax return filing are not subject to the penalty.

Premium Assistance Coverage

The Act provides assistance to low and middle income individuals and families for the purchase of health insurance by creating a premium assistance tax credit for purchase of insurance through an exchange. This credit will be available to individuals and families with incomes up to 400% of the federal poverty level (currently $43,320 for an individual and $88,200 for a family of four). The credit takes the form of a refundable income tax credit. Certain individuals may qualify for an advance determination of their eligibility for the tax credit and may have such credit paid in advance directly to the qualified health plan issuer, thus reducing the out-of-pocket costs paid by such individuals.

Increased Medicare Payroll Tax

Under the Act, the Medicare portion of the payroll tax (applicable generally to wage and self-employment income) will increase from 1.45% to 2.35% for individuals earning more than $200,000 per year and married couples earning more than $250,000 per year. Self-employed individuals meeting the same income thresholds will see an increase to 3.8%. This change will become effective January 1, 2012.

The imposition of this additional tax on payroll income may make Subchapter S corporations and limited partnerships (in certain circumstances) more effective tax vehicles than limited liability companies, due to the fact that amounts of trade or business profit allocated to S corporation shareholders, and in most circumstances, similar allocations made to limited partners of a limited partnership, do not attract the Medicare portion of the FICA tax. Please note, however, that a current proposal before Congress would diminish planning opportunities with S corporations. Those provisions would treat all of the trade or business income of an S corporation as self-employment income in certain circumstances. More information on those changes will be available in a subsequent GSRP publication.

Medicare Tax on Unearned Income

The Act also imposes a 3.8% Medicare tax on unearned income of certain taxpayers. For individuals, the tax will be imposed on the lesser of (a) net investment income or (b) the excess of "modified adjusted gross income" ("MAGI") over the threshold amount of $200,000 for taxpayers filing individually, and $250,000 for married taxpayers filing jointly. In the case of trusts and estates, this new extension of the Medicare tax is imposed on the lesser of the trust's or estate's (a) undistributed net investment income for the year, or (b) any excess of the trust's or estate's adjusted gross income (determined under Internal Revenue Code Section 67(e)) over the dollar limit for which the highest tax bracket for trusts and estates begins for such year (currently $11,200).

- Investment income includes interest, dividends, capital gains, annuities, rents, royalties, passive activity income, and net gain attributable to the disposition of property, other than property held in a trade or business, to the extent included in income. It does not include active trade or business income (including income allocated and distributions made from an S corporation or partnership where the relevant recipient is actively involved in such an entities' trade or business), distributions from individual retirement accounts or other qualified plans, income already taken into account for self-employment purposes, or gain on the sale of an active interest in a partnership or S corporation.
- "Net" investment income is gross investment income less allocable investment expenses.
- "Modified adjusted gross income" is the sum of adjusted gross income and the net foreign income exclusion amount.

As a planning consideration, high income taxpayers may want to increase their contributions to a qualified retirement plan, such as a 401(k) plan or an individual retirement account ("IRA"), since distributions from such plans are not considered "investment income." However, to the extent the distributions from the qualified plan increase a taxpayer's MAGI above the threshold amount, the taxpayer will be subject to the 3.8% surtax on the lesser of the taxpayer's net investment income or the amount that MAGI exceeds the threshold amount. The taxpayer will not be impacted by the additional distribution if there is no net investment income. However, for individuals with net investment income, this nuance should make the Roth 401(k) and Roth IRA more attractive for taxpayers since distributions from these plans are non-taxable and thus neither (a) investment income, nor (b) included in the calculation of MAGI. This highlights the following planning opportunity that exists in 2010-2012 with regard to Roth IRA conversions: a Roth conversion will reduce future MAGI and may therefore lower or eliminate the surtax for individuals who might otherwise be taxed on net investment income.

Family limited partnerships also present an attractive planning opportunity as vehicles to shelter a portion of an individual's net investment income subject to the surtax. Parents can use the family limited partnership structure and down-generational gifting of partnership interests to reduce their own net investment income that may be subject to the surtax, and distribute the interests to a group of individuals who may be below the MAGI threshold. This technique has the added benefit of possibly improving the older generation's estate tax profile, provided the requirements of A. Strangi Est. II and its progeny, and Internal Revenue Code Section 2036 are respected.[1]

Other planning opportunities that have additional merit following the imposition of the surtax include the use of charitable lead trusts, charitable remainder trusts, installment sales, and use of insurance and deferred annuities.

Reimbursement Accounts

The Act restricts reimbursements from flexible spending accounts, health savings accounts, health reimbursement accounts, and Archer medical savings accounts to exclude over-the-counter medications not prescribed by a doctor. This provision is effective beginning January 1, 2011.

Additionally, beginning January 1, 2013, the law lowers the annual contribution amount to flexible spending accounts to $2,500.

Finally, penalties on nonqualified distributions from health savings accounts and Archer medical savings accounts are increased to 20% of the nonqualified distribution, effective for distributions made after December 31, 2010.

Medical Expense Deduction Reduced

Currently, taxpayers can take deductions for unreimbursed medical expenses to the extent such expenses exceed 7.5% of the taxpayer's adjusted gross income. The Act raises this "floor" to 10% of adjusted gross income. This provision becomes effective January 1, 2013. However, the 7.5% adjusted gross income floor will remain at 7.5% through 2016 for individuals age 65 or older.

Dependent Coverage

Under the Act, adult children under the age of 27 are treated as dependents of the taxpayer for purposes of many health coverage-related purposes, regardless of whether such individuals are considered dependents under other provisions of the Internal Revenue Code. This allows parents to exclude from income reimbursements for medical expenses and insurance coverage related to such individuals received from employer-sponsored health plans. If parents are self-employed, they may deduct costs of health insurance coverage for such individuals. Additionally, retired individuals may receive retiree health benefits through a retirement plan for a child under age 27. Finally, voluntary employee benefits associations may provide coverage for an employee's child under age 27. In a related non-tax provision, existing plans that offer coverage of dependents must extend such coverage to adult children under age 27.

Tax Changes Affecting Businesses

"Pay or Play" Rules for "Large" Employers

Under the Act, employers are not required to purchase health insurance for their employees, but the Act imposes a non-deductible penalty on large employers that fail to offer minimum essential coverage to their employees and their dependents. A "large employer" is defined as having more than fifty (50), full-time employees. The number of full-time employees (defined as an employee who works an average of at least 30 hours per week) is determined on an average basis over the preceding year. If a group of employers is treated as a single employer under the qualified retirement plan group rules, then the group will be treated as one employer for purposes of determining the number of employees under the Act.

The tax penalty assessed on an applicable large employer that does not offer adequate insurance coverage is two-pronged. The threshold issue in determining which prong applies is whether the employer offers the opportunity to enroll in minimum essential coverage to its employees and their dependents. For any month in which an applicable large employer fails to offer the opportunity to enroll in minimum essential coverage, and such employer has at least one full-time employee who has been certified to the employer as having enrolled for that month in a qualified health plan offered through a health insurance exchange with respect to which an applicable premium tax credit or cost-sharing reduction is allowed or paid for such employee, the employer will be assessed a penalty equal to the product of the number of the employer's full-time employees (over a 30-employee threshold) multiplied by one-twelfth of $2,000 (or $166.67).

The second prong addresses so-called "offering" employers. An applicable large employer offering coverage will be subject to a penalty in any month in which such employer does offer the opportunity to enroll in minimum essential coverage, but has at least one full-time employee who has been certified to the employer as having enrolled for that month in a qualified health plan offered through a health insurance exchange with respect to which an applicable premium tax credit or cost-sharing reduction is allowed or paid for such employee. The existence of this circumstance is determined by a series of threshold questions. The first threshold is whether the employer contributes to 60% or more of the plan costs. If not, then the employee will be eligible for the premium tax credit or cost-sharing reduction if his or her income falls between 100% and 400% of the federal poverty limits. If the employer's contributions to the plan do meet the 60% threshold, then the second threshold is whether such coverage is "unaffordable" for the employee. Coverage is generally unaffordable if the premium payments required of the employee exceed 9.5% of the employee's household income. The penalty applicable to an employer who does offer coverage, but due to the fact such coverage is "unaffordable," has at least one employee receiving the premium tax credit or cost-sharing reduction, equals the product of the number of employees receiving premium assistance credit or cost-sharing reduction for such month and $250, excluding the first 30 employees. However, this penalty is capped at an amount equal to the product of $166.67 and the total number of full-time employees for that month. Thus, the penalty imposed on an "offering" employer can never exceed the penalty imposed on a non-offering employer with the same number of employees.

Companies should note that even though they may meet the full-time employee threshold to be a "large employer," they will not be considered such under these penalty provisions unless they have at least one full-time employee who is enrolled in a health plan through an insurance exchange and receives a premium assistance tax credit or cost-sharing reduction.

Tax Credits for Small Employers

Small employers will be eligible for a tax credit if they offer health insurance to their employees and cover at least half of the premium cost for such insurance. A "small employer" is one with twenty-five or less full-time employees whose average wages do not exceed $50,000 annually. The credit is graduated and will only apply in-full to those small employers with fewer than 11 full-time employees whose average annual full-time wages do not exceed $25,000. This credit will be accessible in two phases. The first phase occurs during years 2010, 2011, 2012, and 2013, during which a small employer must simply purchase health insurance coverage through a state-licensed insurer. Beginning in 2014, an employer must purchase insurance through an insurance exchange. An employer may only claim a credit for two years under the second phase. During the first phase, the credit equals 35% of the employer's non-elective contributions to employee health insurance premiums. In the second phase, this amount increases to 50%. However, it is phased out as the employer's number of employees and average wages increase.

Vouchers

Beginning January 1, 2014, employers that offer minimum essential coverage to employees and dependents, and pay a portion of such plan's costs, are required to offer free choice vouchers to certain employees who do not participate in the employer-sponsored plan. Individuals whose required contribution for minimum essential coverage through an employer sponsored plan falls between 8% and 9.8% of such individual's household income for the tax year, and whose household income does not exceed 400% of the poverty line for the size of such individual's family, are eligible to receive the free choice voucher.

The amount of the free choice voucher will be equal to the monthly portion of the cost of the employer-sponsored plan that the employer would have paid for such employee had the employee been enrolled in the plan for which the employer pays the largest portion of the cost. The vouchers are excluded from the employee's income to the extent used to obtain qualified health insurance coverage.

Excise Tax on "Cadillac" Insurance Plans

Beginning January 1, 2018, the Act imposes a 40% excise tax on employer-sponsored health plans in which the aggregate value exceeds a certain threshold amount. The basis for calculating the threshold amount is (a) a plan costing $10,200 for an employee with self-only coverage, and (b) $27,500 for an employee with coverage other than self-only coverage.

New IRS Form 1099 Reporting Requirements

The Act greatly expands Form 1099 reporting requirements for persons engaged in a trade or business, including self-employed individuals, who make payments to a single payee totaling more than $600 over the course of one year. Under prior law, payments required to be reported included salaries, wages, commissions, fees, incentive awards and other forms of compensation, interest, rents, royalties, annuities, pensions, and other gains, profits and income.[2] Payments to corporations were one (among many) exception to this requirement.[3] Under the Act, this exception is eliminated for payments made on or after January 1, 2012. In addition, the class of payments required to be reported is greatly expanded under the Act. Beginning January 1, 2012, payments made in consideration for property, and other gross proceeds for property and services, must be reported on Form 1099 if such payments made to one payee exceed $600 in any tax year.

This provision will have a significant impact on the administrative reporting burden of all businesses. For example, a business obtaining new computer equipment would be required to issue the vendor a Form 1099 if such vendor was a corporation. Payments to office supply companies, snack and drink vendors, catering companies, etc., will require a Form 1099 to be issued to the payee if such payments exceed the $600 threshold. As an example, a business that uses Whole Foods, Inc. to provide catering for office lunches or parties will be required to issue a Form 1099 to Whole Foods, Inc.

Conclusion

The Patient Protection and Affordable Care Act and Health Care and Education Reconciliation Act contain numerous complex tax features that will significantly impact individuals and businesses. This summary is intended to provide a general overview of these changes, but their detailed components warrant close attention by all who are affected, which in this case, is just about everyone. Although the new taxes imposed under these laws are significant to both individuals and businesses, readers should take comfort in knowing that tax planning strategies have already been identified which will help reduce the tax burden imposed on individuals and businesses. Individuals and businesses should consult their tax advisor to discuss these planning opportunities.

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[1] *A. Strangi Est. II, TC Memo. 2003-145, aff'd 417 F.2d 468 (5th Cir. 2005).*

[2] *Internal Revenue Code §6041.*

[3] *Treas. Reg. §1.6041-3(p).*

Contact Information

Please contact any of the following persons at GSRP, LLP if you have any questions regarding the application of the FBAR filing requirements to your situation:

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Author's note: Just as this memorandum was being distributed, even more significant tax changes were being introduced in Congress which will further affect many businesses across the U.S. GSRP will continue to monitor and provide updates and analysis of these developments.