GALLAGHER & KENNEDY, P.A.

HEALTH CARE TAX ALERT

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THE TAX CONSEQUENCES OF HEALTH CARE REFORM:
WHAT INDIVIDUALS AND BUSINESSES NEED TO KNOW NOW

On March 23, 2010, President Obama signed the Patient Protection and Affordable Care Act of 2010 into law. Together with the Health Care and Education Reconciliation Act of 2010 (collectively, the "Acts"), signed March 30, 2010, the Acts represent a massive overhaul of the United States' health care system. While the centerpiece of these reforms is the mandate for most residents to obtain health insurance, changes to the United States' federal tax laws constitute a significant part of health care reform. From tax credits, subsidies, and incentives to penalties, fees, and surtaxes, the tax code plays a major role in the Acts' implementation. Many of the new requirements have phased-in and delayed effective dates, giving both the IRS and taxpayers time to prepare. Although it is anticipated that additional guidance will continue to be released, in the interim, set forth below is a summary of the major tax changes impacting individuals and businesses.

TAX CHANGES IMPACTING INDIVIDUALS:

1. *Penalty for Remaining Uninsured*. Currently, only residents of Massachusetts are required to have health insurance. However, beginning in 2014, non-exempt U.S. citizens and legal residents will be required to maintain "minimum essential coverage." Those without coverage will face a penalty equal to the greater of (i) $695 per year, up to a maximum of $2,085 per family; or (ii) 2.5% of household income over the income tax filing threshold (in 2010, the threshold for taxpayers under the age of 65 is $9,350 for single taxpayers and $18,700 for couples). The penalty will be phased in over three years, with the full penalty not imposed until 2016.

Exemptions will be granted for financial hardship, religious objectors, American Indians, incarcerated individuals, those for whom the lowest cost plan option exceeds 8% of household income, those with incomes below the tax filing threshold, and those residing outside the U.S.

2. *Low-Income Tax Credits*. Also beginning in 2014, a refundable tax credit (the "Premium Assistance Credit") will be available for eligible individuals and families who purchase health insurance through a "health insurance exchange." The Premium Assistance Credit will be available to individuals and families with incomes up to 400% of the federal poverty level (in 2009, the poverty level was $43,320 for an individual or $88,200 for a family of four) that are not eligible for Medicaid, employer-sponsored insurance, or other acceptable coverage.

Under the provision, an eligible individual will enroll in a health insurance plan offered through a health insurance exchange and will report his or her income to the exchange. The IRS will then pay the Premium Assistance Credit directly to the exchange, and the individual will only be obligated to pay the difference.

3. *Increased Taxes for High-Income Taxpayers*. Beginning in 2013, single taxpayers earning more than $200,000 and married couples earning more than $250,000 will be subject to an additional 0.9% tax on wages in excess of those base amounts. Employers will be obligated to collect the extra tax and remit it to the IRS.

In addition, a new 3.8% tax (called the "Unearned Income Medicare Contribution") will be imposed on the net investment income of single taxpayers with adjusted gross income above $200,000 and joint filers with adjusted gross income above $250,000. The new tax only applies to the income in excess of the $200,000/$250,000 thresholds.

4. *Medical Benefits for Children Under 27*. Effective March 30, 2010, the Acts require group health plans and health insurance issuers that provide dependent coverage of children to continue to make such coverage available for an adult child until age 26. The Acts also amend the Internal Revenue Code to

give certain favorable tax treatment to coverage for adult children.

5. _Excise Tax on Indoor Tanning Services_. The Acts impose a 10% excise tax on indoor tanning services. The tax will be paid by the individual on whom the tanning services are performed and takes effect on July 1, 2010.

6. _Limits on FSA Contributions_. A health flexible spending arrangement ("FSA") is a tax-advantaged financial account that can be set up through a cafeteria plan of an employer. An FSA allows an employee to set aside a portion of his or her earnings to pay for qualified medical expenses. Beginning in 2013, contributions made to FSAs will be capped at $2,500 per year.

7. _Restricted Definition of Medical Expenses_. Beginning in 2011, individuals will no longer be able to be reimbursed through a health reimbursement account for over-the-counter drugs.

8. _Increased Tax on Nonqualifying HSA or Archer MSA Distributions_. In 2011, an individual who makes a withdrawal from a health savings account ("HSA") or an Archer Medical Savings Account ("MSA") for any purpose, other than qualified medical expenses, will be subject to an increased tax of 20% on the withdrawal.

9. _Modified Threshold for Claiming Medical Expense Deductions_. Under current law, taxpayers can take an itemized deduction for unreimbursed medical expenses only to the extent that those expenses exceed 7.5% of the taxpayer's adjusted gross income ("AGI"). The new law raises the AGI floor to 10%, beginning in 2013. However, the AGI floor for individuals age 65 and older will remain 7.5% through 2016.

10. _Adoption Credits and Assistance_. Beginning in 2010, the adoption tax credit is increased by $1,000, made refundable, and extended through 2011. The adoption assistance exclusion is also increased by $1,000.

TAX CHANGES IMPACTING BUSINESSES:

1. _"Pay or Play" Penalties_. In 2014, a large employer that does not offer medical insurance coverage for its full-time employees will be subject to a penalty. However, only an applicable large employer, defined as someone who employs an average of at least 50 full-time employees, is subject to the requirement. The penalty for any month is an excise tax equal to the number of full-time employees (over a 30-employee threshold) multiplied by $167.67.

2. _Free Choice Vouchers_. Also beginning in 2014, employers offering minimum essential coverage through an eligible employer-sponsored plan and paying a portion of that coverage will have to provide qualified employees with a voucher, the value of which can be applied to purchase a health plan through an insurance exchange. Qualified employees are those employees who do not participate in the employer-sponsored plan, whose required contribution for employer-sponsored minimum essential coverage (if they did participate in the plan) exceeds 8% (but does not exceed 9.5%) of household income, and whose total household income does not exceed 400% of the poverty line for the family. If an individual receives a voucher, he or she is disqualified from receiving any tax credit or cost sharing credit for the purchase of a plan through an insurance exchange.

3. _Tax Credits for Small Employers_. The Acts provide small employers with a tax credit for nonelective contributions to purchase health insurance for their employees. To qualify, the business must offer health insurance and contribute at least one-half of the total premium cost. The business must have no more than 25 full-time equivalent employees and the employees must have average annual wages of no more than $50,000. The credit is initially available for any tax year beginning in 2010, 2011, 2012, or 2013. After 2013, the credit is only available if the employer purchases health insurance through a state exchange. Until 2013, the credit is generally 35% of the employer's contributions and phases out as firm-size and average wages increase.

4. _Excise Tax on High-Cost Employer-Sponsored Plans_. Beginning in 2018, a 40% nondeductible excise tax will be levied on insurance companies and plan administrators for any health coverage plan to the extent that the annual premium exceeds $10,200 for single coverage and $27,500 for family coverage. Although the tax is not imposed on the employers themselves, it is expected that employers and workers

will ultimately bear this tax in the form of higher insurance premiums passed on by insurers.

5. _Employer Reporting Responsibilities_. In 2011, employers must disclose the value of the benefit provided by them for each employee's health insurance coverage on the employee's annual Form W-2.

6. _Deduction for Part D Eliminated_. In 2013, the deduction for the subsidy for employers who maintain prescription drug plans for their Medicare Part D eligible retirees will be eliminated.

7. _Fees for Drug and Insurance Companies_. Beginning in 2011, pharmaceutical manufacturers and importers will have to pay an annual flat fee allocated across the industry according to market share. In addition, health insurance providers will face an annual flat fee on the health insurance sector, beginning in 2014.

8. _Corporate Information Reporting_. For payments made after December 31, 2011, businesses that pay any amount greater than $600 during the year to corporate providers of property and services will have to file an information report (generally, a Form 1099) with each provider and the IRS.

9. _Codification of Economic Substance Doctrine_. The economic substance doctrine provides that the tax benefits of a transaction are not allowed if the transaction does not have economic substance or lacks a business purpose. Previously used by judges in an attempt to enforce the statutory provisions of the tax code, the Acts codify the doctrine and impose strict penalties. If a transaction lacks economic substance, a taxpayer is subject to a penalty of 20%, increased to 40% if the transaction was not disclosed to the IRS.

10. _Estimated Taxes for Large Corporations_. The estimated tax payment required to be made by a large corporation (assets of at least $1 billion) in July, August, or September of 2014 has been increased to 173.5% of the amount otherwise due.

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