

Historic Health Care Legislation Includes Important Tax Changes for Individuals & Businesses



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After months of heated debate and last-minute changes, Congress has passed and President Obama has signed into law the *Patient Protection and Affordable Care Act* (Patient Protection Act). In addition, the *Health Care and Education Tax Credits Reconciliation Act of 2010* (Reconciliation Act) is currently awaiting the president's signature. Together, these two acts will reform the health care system and affect virtually all taxpayers. This article will highlight key tax provisions included in the Patient Protection Act as well as changes to those provisions or new tax provisions currently proposed by the Reconciliation Act.

Individuals

Key tax provisions affecting individuals include:

- **Excise tax for remaining uninsured.** Effective in 2014, individuals would be required to maintain minimum insurance coverage unless they are covered by Medicaid, Medicare or other government-sponsored coverage. Failure to obtain insurance will result in a penalty equal to the greater of a flat amount or a certain percentage of income. Under the Reconciliation Act, the penalty amounts would be \$95 per person without minimum coverage in 2014, \$325 in 2015, \$695 in 2016 and indexed for inflation thereafter. The percent of income amounts under the Reconciliation Act would be 1 percent in 2014, 2 percent in 2015 and 2.5 percent for 2016 and subsequent years. The total annual penalty is determined monthly and cannot exceed 300 percent of the flat penalty amount, e.g., \$2,085 for 2016.
- **Increased Medicare tax on earned income.** Effective in 2013, an additional 0.9 percent Medicare tax would apply on wages in excess of \$200,000 (\$250,000 for joint returns). The additional tax applies only to the employee portion, i.e., the employer is not required to also pay the additional Medicare tax. An employer is required to withhold the 0.9 percent Medicare tax only to the extent it pays more than \$200,000 of wages to an employee and must disregard the amount of wages earned by the employee's spouse. For self-employed individuals, the 0.9 percent tax applies on self-employment income in excess of the same threshold amounts. The additional tax paid cannot be deducted as part of the deduction for one-half of self-employment taxes.
- **Medicare tax on investment income.** The Reconciliation Act includes a provision that, effective 2013, would impose a Medicare tax of 3.8 percent on the lesser of net investment income or the excess of an individual's adjusted gross income more than \$200,000 (\$250,000 for joint returns). Investment income would include interest, dividends, rents, royalties, gains on sales of certain property and ordinary income from passive activities. Investment income is reduced by deductions properly allocated to such income, e.g., investment interest expense, investment management fees, etc.
- **Medical expense deduction threshold raised.** Effective in 2013, the threshold to claim an itemized deduction for unreimbursed medical expenses increases from 7.5 percent of adjusted gross income to 10 percent. However, for tax years 2013 through 2016, the increased threshold would not apply if the taxpayer or taxpayer's spouse turns 65 before the end of the year. For alternative minimum tax purposes, the threshold is still 10 percent.
- **Increase in tax for Health Savings Account (HSA) distributions not used for medical expenses.** Effective in 2011, distributions from an HSA or Archer Medical Savings Account (MSA) not used to pay qualifying medical expenses will be subject to an additional 20 percent tax. Prior to 2011, the additional tax on nonqualified distributions from HSAs and MSAs is 10 percent and 15 percent, respectively.
- **Limitation on health flexible spending arrangement (FSA) contributions.** Effective 2011 (2013 under the Reconciliation Act), contributions employees can make to FSA plans offered by their employers will be limited to \$2,500. The \$2,500 limit will be indexed for inflation for years after 2013.
- **Over-the-counter medication no longer qualifying medical expense.** Effective 2011, over-the-counter medicines may not be reimbursed through an FSA or treated as qualifying medical expenses for purposes of HSA and MSA distributions. Exceptions apply for doctor-prescribed over-the-counter medicines and insulin.

Businesses

Key provisions affecting businesses include:

- **Penalty for not providing minimum essential coverage.** Effective in 2014, an employer that does not offer minimum essential coverage to its full-time employees would be subject to a nondeductible penalty if any full-time employee is certified by the employer as having purchased health insurance through a state exchange and receiving a premium assistance credit or cost-sharing reduction. This would apply only to employers with 50 or more full-time employees. The penalty amount is calculated for each month coverage is not met by multiplying one-twelfth of \$750 (\$2,000 under the Reconciliation Act) times the number of full-time employees less 30.

- **Excise tax on high-cost, employer-sponsored health care plans.** Effective in 2013 (2018 under the Reconciliation Act), a 40 percent nondeductible excise tax will apply if the aggregate value of employer-sponsored health insurance coverage for an employee exceeds a threshold amount. Under the Reconciliation Act, the threshold amounts are \$10,200 for individual coverage and \$27,500 for family coverage. Adjustments to the thresholds would be made for certain high-risk professions, as well as plans that have higher premiums due to participants' age or gender. The excise tax is levied at the insurer level, and employers would be required to report the amount subject to excise tax to the insurer. The tax applies to self-insured plans and plans sold in the group market. Dental and vision plans are excluded.
- **New reporting requirement on W-2.** Effective in 2011, employers will be required to disclose on each employee's W-2 the value of the employee's health insurance coverage sponsored by the employer.
- **Annual fees imposed on certain health-related industries.** Businesses in the brand name pharmaceutical, health insurance provider and medical device manufacturing industries would be subject to an annual nondeductible fee. The total annual fee applicable to each industry would be allocated to each business within that industry based on market share as determined by the Secretary of Treasury. Effective date for the brand name pharmaceutical and health insurance provider industries is 2010 (2011 and 2014, respectively under the Reconciliation Act). For the medical device manufacturing industry, the Reconciliation Act repeals the annual fee, which was set to begin in 2010, and replaces it with an excise tax equal to 2.3 percent of the sale price of certain medical devices sold by the manufacturer, producer or importer of such device after December 31, 2012. Certain medical devices would be exempt from the excise tax, including eyeglasses, contact lenses, hearing aids and any other medical device determined by the IRS to generally be purchased by the general public for individual use.
- **Excise tax on indoor tanning services.** Effective for services provided on or after July 1, 2010, a tax equal to 10 percent of the amount paid for tanning services must be collected from the customer. The tanning service provider must remit these taxes quarterly to the IRS. Phototherapy services performed by a licensed medical professional are excluded.
- **Expanded information reporting requirements for payments to corporations.** Effective for payments made after December 31, 2011, a business will be required to file an information return, *i.e.*, a 1099 form, to report payments totaling \$600 or more to corporate and noncorporate payees.
- **Codification of Economic Substance Doctrine.** The courts have often applied a judicial doctrine known as the Economic Substance Doctrine to deny tax benefits arising from transactions that do not result in a meaningful change to the taxpayer's economic position other than a purported reduction in federal income tax. The Reconciliation Act would codify the doctrine into the Internal Revenue Code. Effective for transactions entered into after the date of enactment, economic substance is satisfied only if the transaction changes the taxpayer's economic position in a meaningful way (apart from federal income tax effects) and the taxpayer has a substantial purpose for entering into such transaction, other than the purported federal tax benefits. Underpayments resulting from transactions that lack economic substance are subject to a 20 percent penalty, increased to 40 percent depending on the transaction and level of disclosure.

Stay tuned for additional insight on the numerous changes resulting from the Patient Protection Act and Reconciliation Act. For more information, please contact your BKD advisor.