

## U.S. Healthcare System



In March, Congress passed two pieces of legislation designed to reform the U.S. health care system. The Patient Protection and Affordable Care Act (PL 111-148) was enacted on March 23, and was quickly followed by the Health Care and Education Reconciliation Act of 2010 (PL 111-152), which amended several portions of the first act, as well as adding new provisions of its own. While the legislation generally deals with the health care system, it contains many revisions to the Internal Revenue Code. Individuals and businesses are affected and are likely to look to their accountants and financial advisers for guidance and compliance help.

Among other things, the legislation provides a credit to help individuals afford insurance; it also imposes a penalty on individuals who do not obtain health insurance. Small businesses that provide health coverage for their employees are also eligible for a credit; large businesses that provide inadequate health coverage are subject to an excise tax. The medical deduction threshold is increased to 10% of adjusted gross income. And, in a provision not related to health care, Forms 1099 will now be required for payments of \$600 or more to corporations.

Please note that most of these items do not take effect until future years.

### PROVISIONS FOR INDIVIDUALS

**Premium assistance credit.** The Patient Protection Act provides for a refundable tax credit that eligible taxpayers can use to help cover the cost of premiums for health insurance purchased through a state health benefit exchange (which each state is required to establish under the act). Under new IRC § 36B, an eligible individual will enroll in a plan offered through an exchange and report his or her income to the exchange. Based on the information provided to the exchange and his or her income, the individual will receive a premium assistance credit. The Treasury Department will pay the premium assistance credit amount directly to the insurance plan in which the individual is enrolled. The individual will then pay to the plan in which he or she is enrolled the dollar difference between the premium tax credit amount and the total premium charged for the plan. Alternatively, eligible individuals can pay for the insurance out of pocket and then claim the credit on their tax returns.

Eligibility for the premium assistance credit is based on the individual's income for the tax year ending two years prior to the enrollment period. The premium assistance credit is available for individuals (single or joint filers) with household incomes between 100% and 400% of the federal poverty level (for the family size involved) who do not received health insurance through an employer or a spouse's employer. The credit amount is determined by the secretary of Health and Human Services, based on the amount by which premiums exceed a threshold amount. The threshold rises from 2% of income for those at 100% of the federal poverty level for the family size involved to 9.5% of income for those at 400% of the federal poverty level for the family size involved.

The Reconciliation Act provides for an inflation adjustment in the starting and ending percentages for years after 2014. The adjustment will be based on the rate of premium growth for the preceding calendar year over that year's rate of income growth.

After 2018, the inflation adjustment will be based on the rate of premium growth for the preceding calendar year over that year's consumer price index growth, but only if the aggregate amount of premium assistance tax credits

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and cost-sharing reductions (under section 1402 of the Patient Protection Act) for the preceding calendar year exceeds an amount equal to 0.504% of the gross domestic product for the preceding calendar year.

The premium assistance credit will be available for years ending after Dec. 31, 2013.

§ **Excise tax on uninsured individuals.** The Patient Protection Act creates new IRC § 5000A, which requires U.S. citizens and legal residents to maintain minimum amounts of health insurance coverage. Minimum essential coverage includes various government-sponsored programs, eligible employer-sponsored plans, plans in the individual market, grandfathered group health plans, and other coverage as recognized by the secretary of Health and Human Services in coordination with the Treasury secretary. The coverage requirement would not apply to individuals who are incarcerated, are not legally present in the United States, or qualify for a religious exemption.

Individuals who fail to maintain minimum essential coverage will be subject to a penalty equal to the greater of (1) 2.5% of the amount by which the taxpayer's household income for the tax year exceeds the threshold amount of income required for income tax return filing under section 6012(a)(1); or (2) \$695 per uninsured adult in the household. The penalty will be phased in from 2014–2016. For 2014, the penalty will be the greater of 1% of household income over the filing threshold or \$95; for 2015, it will be the greater of 2% of household income over the filing threshold or \$325; and for 2016 it will be the full 2.5% or \$695.

The act specifies that liens and seizures are not authorized to enforce this penalty, and noncompliance will not be subject to criminal penalties. The excise tax on uninsured individuals has been criticized as unconstitutional, and it has been challenged in a lawsuit brought by several state attorneys general (*Florida v. Dept. of Health and Human Services*, docket no. 3:10-cv-00091-RV-EMT (N.D. Fla., filed 3/23/10)).

This provision is effective for tax years beginning after Dec. 31, 2013.

§ **Adult dependent.** The Reconciliation Act raises the age up to which parents can carry their children on their health insurance policy. It does this by changing the definition of “dependent” for purposes of IRC § 105(b) (excluding from income amounts received under a health insurance plan) to include amounts expended for the medical care of any child of the taxpayer who has not yet reached age 27. The same change is made in section 162(l)(1) for purposes of the self-employed health insurance deduction, in section 501(c)(9) for purposes of benefits provided to members of a VEBA, and in section 401(h) for benefits for retirees. These changes were effective upon enactment.

§ **Medical care itemized deduction threshold.** The threshold for the itemized deduction for unreimbursed medical expenses is increased from 7.5% of AGI to 10% of AGI for regular income tax purposes. This is effective for tax years beginning after Dec. 31, 2012, except that in the years 2013–2016, if either the taxpayer or the taxpayer's spouse has turned 65 before the end of the tax year, the increased threshold does not apply and the threshold remains at 7.5% of AGI.

§ **Additional hospital insurance tax on high-income taxpayers.** Under the Patient Protection Act, the employee portion of the hospital insurance tax part of FICA, currently 1.45% of covered



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wages, is increased by 0.9% on wages that exceed a threshold amount. The additional tax is imposed on the combined wages of both the taxpayer and the taxpayer's spouse, in the case of a joint return. The threshold amount is \$250,000 in the case of a joint return or surviving spouse, \$125,000 in the case of a married individual filing a separate return, and \$200,000 in any other case.

For self-employed taxpayers, the same additional hospital insurance tax applies to the hospital insurance portion of SECA tax on self-employment income in excess of the threshold amount.

The provision applies to remuneration received and tax years beginning after Dec. 31, 2012.

- § **Medicare tax on investment income.** The Reconciliation Act added a new IRC § 1411 that imposes a tax on individuals equal to 3.8% of the lesser of the individual's net investment income for the year or the amount the individual's modified adjusted gross income exceeds a threshold amount. For estates and trusts, the tax equals 3.8% of the lesser of undistributed net investment income or adjusted gross income over the dollar amount at which the highest trust and estate tax bracket begins.

For married individuals filing a joint return and surviving spouses, the threshold amount is \$250,000; for married taxpayers filing separately, it is \$125,000; and for other individuals it is \$200,000.

Net investment income means investment income reduced by deductions properly allocable to that income. Investment income is defined as income from interest, dividends, annuities, royalties and rents, and net gain from disposition of property, other than such income derived in the ordinary course of a trade or business (however, income from passive activities and from a trade or business of trading in financial instruments or commodities is included in the definition of net investment income).

This provision applies to tax years beginning after Dec. 31, 2012.

- § **Return information disclosure.** The Patient Protection Act allows the IRS, upon written request of the secretary of Health and Human Services, to disclose certain taxpayer return information if the taxpayer's income is relevant in determining the amount of the tax credit or cost-sharing reduction or eligibility for participation in the specified state health subsidy programs.

Upon written request from the commissioner of Social Security, the IRS may disclose certain limited return information of a taxpayer whose Medicare Part D premium subsidy, according to the records of the Treasury secretary, may be subject to adjustment.

- § **Flexible spending arrangement.** The Patient Protection Act mandates that the maximum amount available for reimbursement of incurred medical expenses of an employee, the employee's dependents, and any other eligible beneficiaries with respect to the employee, under a health flexible spending arrangement for a plan year (or other 12-month coverage period) must not exceed \$2,500. The provision is effective for tax years beginning after Dec. 31, 2012.

- § **Restrictions on use of HSA and FSA funds.** Under the Patient Protection Act, amounts paid for over-the-counter medications will no longer be reimbursable from health savings accounts (HSAs), Archer medical savings accounts (MSAs), health FSAs, or health reimbursement arrangements. Amounts paid for a drug will only meet the definition of "qualified medical expenses" in sections 106, 220 and 223 if the drug is a prescribed drug (or is insulin). This provision is effective for amounts paid or expenses incurred after Dec. 31, 2010.

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- § **Tax on HSA distributions.** The additional tax on distributions from an HSA or an Archer MSA that are not used for qualified medical expenses is increased to 20% of the disbursed amount, effective for disbursements made during tax years starting after Dec. 31, 2010. (Under prior law, the tax was 10% of the disbursed amount for HSAs and 15% for Archer MSAs.)
- § **Cafeteria plans.** The Patient Protection Act makes premiums for coverage under a qualified health plan offered through an exchange a qualified benefit under a cafeteria plan. This provision applies only to cafeteria plans established by a small employer that elects to make all its full-time employees eligible for one or more qualified plans offered in the small group market through an exchange.

This provision is effective for tax years beginning after Dec. 31, 2013.

## PROVISIONS FOR BUSINESSES

**Small business tax credit.** The Patient Protection Act provides tax credits for small businesses and individuals designed to increase levels of health insurance coverage, as part of the IRC § 38 general business credit. Small businesses—defined as businesses with 25 or fewer employees and average annual wages of less than \$50,000—are eligible for a credit of up to 50% of non-elective contributions the business makes on behalf of its employees for insurance premiums (new IRC § 45R). Tax-exempt organizations would get a 35% credit against payroll taxes.

Employers with 10 or fewer employees and average wages of less than \$25,000 will get 100% of the credit; for other eligible employers, the credit will be reduced based on the number of employees over 10 and the excess of the employees' average wages over \$25,000. The \$25,000 average annual wages figure will be indexed for inflation after 2013.

This credit is available for tax years beginning after Dec. 31, 2009, and is phased in from 2010 through 2013. During the phase-in years, the maximum credit is 35% of the employer's eligible premium expense (25% for tax-exempt employers).

**Employer responsibility.** Under new IRC § 4980H, an “applicable large employer” that does not offer coverage for all its full-time employees, offers minimum essential coverage that is unaffordable, or offers minimum essential coverage that consists of a plan under which the plan's share of the total allowed cost of benefits is less than 60%, is required to pay a penalty if any full-time employee is certified to the employer as having purchased health insurance through a state exchange with respect to which a tax credit or cost-sharing reduction is allowed or paid to the employee.

An employer is an applicable large employer with respect to any calendar year if it employed an average of at least 50 full-time employees during the preceding calendar year.

The penalty for any month is an excise tax equal to the number of full-time employees over a 30-employee threshold during the applicable month (regardless of how many employees are receiving a premium tax credit or cost-sharing reduction) multiplied by \$166.67 (one-twelfth of \$2,000).

This provision is effective for months beginning after Dec. 31, 2013.

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**Prescription drug coverage deduction.** The Patient Protection Act eliminates the IRC § 139A deduction for employers who subsidize prescription drug coverage for their employees who are eligible for Medicare Part D. This provision is effective for tax years beginning after Dec. 31, 2010.

**Reporting requirements.** The Patient Protection Act requires insurers (including employers who self-insure) that provide minimum essential coverage to any individual during a calendar year to report certain health insurance coverage information to both the covered individual and to the IRS (new IRC § 6055).

The information required to be reported includes: (1) the name, address and taxpayer identification number of the primary insured, and the name and taxpayer identification number of each other individual obtaining coverage under the policy; (2) the dates during which the individual was covered under the policy during the calendar year; (3) whether the coverage is a qualified health plan offered through an exchange; (4) the amount of any premium tax credit or cost-sharing reduction received by the individual with respect to such coverage; and (5) such other information as the Treasury secretary may require.

This requirement is effective for calendar years beginning after 2013.

**Information reporting.** The Patient Protection Act requires employers to disclose on each employee's annual Form W-2 the value of the employee's health insurance coverage sponsored by the employer, effective for tax years beginning after Dec. 31, 2010.

**Tax-exempt health insurers.** The Patient Protection Act provides for a program administered by the Department of Health and Human Services to encourage the creation of qualified nonprofit health insurance issuers to offer health insurance. Insurers receiving federal grants or loans under the program would be exempt from federal tax (under IRC § 501(a)) for periods when the insurer complies with the terms of the program.

**Fees on health plans.** Under new IRC § 4375, a fee is imposed on each specified health insurance policy. The fee is equal to \$2 (\$1 in policy years ending during fiscal year 2013) multiplied by the average number of lives covered under the policy. The issuer of the policy is liable for payment of the fee.

New IRC § 4376 imposes a similar fee on self-insured health plans, equal to \$2 (\$1 in policy years ending during fiscal year 2013) multiplied by the average number of lives covered under the plan.

For any policy year beginning after Sept. 30, 2014, under both IRC §§ 4375 and 4376, the dollar amount is equal to the sum of the dollar amount for policy years ending in the preceding fiscal year plus an amount equal to the product of (1) the dollar amount for policy years ending in the preceding fiscal year, multiplied by (2) the percentage increase in the most recent projected per capita amount of national health expenditures.

The fee is effective with respect to policies and plans for portions of policy or plan years beginning on or after Oct. 1, 2012.

**Charitable hospitals.** The Patient Protection Act establishes new requirements applicable to section 501(c)(3) hospitals, regarding conducting a community health needs assessment, adopting a written financial assistance policy, limitations on charges, and collection activities.

**Excise tax on high-cost employer plans.** New IRC § 4980I imposes an excise tax on insurers if the aggregate value of employer-sponsored health insurance coverage for an employee (including, for purposes of the provision,

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any former employee, surviving spouse and any other primary insured individual) exceeds a threshold amount. The tax is equal to 40% of the aggregate value that exceeds the threshold amount. For 2018, the threshold amount is \$10,200 for individual coverage and \$27,500 for family coverage, multiplied by the health cost adjustment percentage (as defined in the act) and increased by the age and gender adjusted excess premium amount (as defined in the act).

Retirees and employees in certain high-risk professions or who repair or install electrical or telecommunications lines have a higher limit. After 2018, the annual limitation is adjusted for inflation.

The provision is effective for tax years beginning after Dec. 31, 2017.

**Medical device excise tax.** The Reconciliation Act added new IRC § 4191, which imposes a 2.3% excise tax on sales of certain medical devices. The tax applies to sales of any medical device intended for humans (as defined in section 201(h) of the Federal Food, Drug, and Cosmetic Act (21 U.S.C. § 321(h))), except eyeglasses, contact lenses, hearing aids, and medical devices generally sold at retail to the public for individual use. This provision is effective for sales after Dec. 31, 2012.

**SIMPLE cafeteria plans for small businesses.** The Patient Protection Act establishes a SIMPLE cafeteria plan for small businesses. Under the provision, an eligible small employer is provided with a safe harbor from the nondiscrimination requirements for cafeteria plans as well as from the nondiscrimination requirements for specified qualified benefits offered under a cafeteria plan, including group term life insurance, benefits under a self-insured medical expense reimbursement plan, and benefits under a dependent care assistance program. Under the safe harbor, a cafeteria plan and the specified qualified benefits are treated as meeting the specified nondiscrimination rules if the cafeteria plan satisfies minimum eligibility and participation requirements and minimum contribution requirements.

The provision is effective for tax years beginning after Dec. 31, 2010.

### Implementation Schedule

<b>2010</b>	Small business tax credit Adoption credit increase Adoption-assistance program increase Tanning excise tax
<b>2011</b>	Prescription drug coverage deduction eliminated W-2 reporting SIMPLE cafeteria plans Restrictions on use of HSA and FSA funds for over-the-counter drugs Tax on HSA distributions increase
<b>2012</b>	1099s required for payments to corporations Adoption credit sunset Adoption-assistance programs sunset
<b>2013</b>	Increase in medical deduction threshold for taxpayers under age 65 Additional hospital insurance tax on high-income taxpayers Medicare tax on investment income

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	Fees on health plans (after Oct. 1, 2012) Medical device excise tax Flexible spending arrangement maximum imposed
<b>2014</b>	Premium assistance credit Excise tax on uninsured individuals Excise tax on applicable large employers Insurer reporting requirements Eligible premiums included in cafeteria plans
<b>2017</b>	Increase in medical deduction threshold for taxpayers age 65 and over
<b>2018</b>	Excise tax on high-cost employer plans

### Other Provisions not related to Health Care

The health care legislation contains several tax provisions unrelated to health care. These include:

**Information reporting.** The Patient Protection Act requires businesses to file an information return (for example, a Form 1099) for all payments aggregating \$600 or more in a calendar year to a single payee, including corporations (other than a payee that is a tax-exempt corporation). The provision is effective for payments made after Dec. 31, 2011.

**Expansion of adoption credit, adoption-assistance programs.** For 2010, the maximum adoption credit is increased to \$13,170 per eligible child (a \$1,000 increase). This increase applies to both non-special-needs adoptions and special-needs adoptions. Also, the adoption credit is made refundable. The new dollar limit and phase-out of the adoption credit are adjusted for inflation in tax years beginning after Dec. 31, 2010. The scheduled sunset of Economic Growth and Tax Relief Reconciliation Act (EGTRRA) provisions relating to the adoption credit is delayed for one year (that is, the sunset becomes effective for tax years beginning after Dec. 31, 2011).

For adoption-assistance programs, the maximum exclusion is increased to \$13,170 per eligible child (a \$1,000 increase). The new dollar limit and income limitations of the employer-provided adoption-assistance exclusion are adjusted for inflation in tax years beginning after Dec. 31, 2010. The EGTRRA sunset of provisions relating to adoption-assistance programs is also delayed for one year (that is, the sunset becomes effective for tax years beginning after Dec. 31, 2011). Under the sunset, after 2011, the adoption credit will revert to its pre-EGTRRA provisions (that is, a \$6,000 credit for special-needs children only), and the income exclusion will disappear.

**Economic substance doctrine.** The Reconciliation Act codifies the economic substance doctrine in new IRC § 7701(o). The provision says that a transaction will be treated as having economic substance only if the transaction changes the taxpayer's position in a meaningful way (apart from the tax benefits) *and* the taxpayer has a substantial purpose (apart from the tax benefits) for entering into the transaction.

The economic substance doctrine was created by the courts, and while they agree about the general definition and purpose, they have applied various tests in determining whether a transaction has economic substance. The act codifies a two-part test and requires transactions to meet both prongs of the test.

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The Reconciliation Act puts failure to meet the economic substance test within the list of transactions that are subject to penalty under IRC § 6662 and imposes an increased penalty amount for non-disclosed transactions that lack economic substance. The act also removes transactions that lack economic substance from the reasonable cause exception in IRC § 6664.



***Tax on indoor tanning services.*** The Patient Protection Act imposes a 10% tax on amounts paid for indoor tanning services (new IRC § 5000B). Like a sales tax, the tax will be collected from the person tanning when payment for the tanning services is made. The provision applies to services performed on or after July 1, 2010.

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