

Dear Clients and Friends:

On March 23, 2010, the President signed The Patient Protection and Affordable Care Act (Act). The Act, which was passed by the House of Representatives on March 21st and previously by the U.S. Senate this past December 24th, represents enactment of a comprehensive health care reform bill. The new law is slated to raise taxes on individuals, businesses, high cost group health plans, along with new fees on selected health care industries by nearly \$400 billion over the next 10 years. Separately, the House passed a package of modifications (Reconciliation) that if passed by the Senate, will significantly alter many provisions of the Act. Plans are under way to move the Reconciliation through the Senate in the coming days. The Act along with its sister legislation, the Reconciliation, are both far reaching in their scope and ground breaking in their impact.

In this Tax Alert we will analyze the major tax and certain non-tax provisions of the Act, along with the proposed changes imbedded in the Reconciliation.

Revenue Provisions

EXCISE TAX ON HIGH-COST EMPLOYER SPONSORED HEALTH COVERAGE

The Act

For tax years beginning after December 31, 2012, the Act would place a 40% nondeductible excise tax on insurance companies and plan administrators for any health coverage plan to the extent that the annual premium exceeds \$8,500 for single coverage and \$23,000 for family coverage (the so called Cadillac Plans). An additional threshold amount of \$1,350 for single coverage and \$3,000 for family coverage would apply to retired individuals age 55 and older and for plans that cover employees engaged in high-risk professions.

The excise tax would be levied at the insurer level. Employers would be required to aggregate the coverage subject to the limit and issue information return for insurers indicating the amount subject to the excise tax. To the extent that coverage is provided under an employer plan, the issuer of the coverage is liable for the tax. The plan administrator must pay the tax in the case of self-insured group health plan, or a health flexible spending arrangement (FSA). The employer must pay with respect to employer contributions to a health savings account (HSA) or medical savings account (MSA).

In determining the aggregate cost, all employer provided health insurance coverage is taken into account, including reimbursements under FSA, and coverage for dental, vision, and other supplementary health insurance. Employers would be penalized for undervaluing the insurance cost subject to the excise tax.

The excise tax phases in for the 17 "highest cost" states for employer-provided health insurance coverage. In the "highest cost" states, the excess benefit threshold for a high-cost plan is 120% for 2013 (\$27,600 for family/\$10,200 single), phasing down to 110% for 2014, and 105% for 2015. This transition ends for taxable years beginning after 2015 when the increased threshold for plans in high-cost states is eliminated.

The Reconciliation

The Reconciliation would delay implementation of the excise tax on these plans until 2018. Additionally, the Reconciliation modifies the excise tax in other manners.

1. The threshold for the tax would be increased from \$23,000 to \$27,500 of annual premium for families and from \$8,500 to \$10,200 for individuals. The premium thresholds would be further increased in 2018 if Congressional Budget Office projections regarding premium inflation between 2010 and 2018 underestimate cost growth.
2. Dental and vision plans would not be included when calculating the total benefit value.
3. Phase-ins for the "highest cost" states would be eliminated. Fourth, the premium thresholds for retirees and employees in high-risk professions would increase from \$3,000 to \$3,450 for families and from \$1,350 to \$1,650 for individuals.
4. The Reconciliation would modify the cost of living adjustment for years after 2019. For those years, the adjustment will be based on the Consumer Price Index for Urban Consumers (CPI-U).

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ADDITIONAL HOSPITAL INSURANCE TAX FOR HIGH WAGE WORKERS

The Act

Beginning in 2013, the Act imposes an additional 0.9% Medicare Hospital Insurance tax (HI tax) on self-employed individuals and employees with respect to earnings and wages received during the year above specified thresholds. This additional tax applies to earnings of self-employed individuals or wages of an employee received in excess of \$200,000. If an individual or employee files a joint return, then the tax applies to all earnings and wages in excess of \$250,000 on that return. The Act does not change the employer HI tax. Self-employed individuals are not permitted to deduct any portion of the additional tax. Thresholds for the additional HI tax are not indexed for inflation.

The Reconciliation

For tax years beginning after December 31, 2012, the Reconciliation would broaden the HI tax base by placing a 3.8% surtax called the Unearned Income Medicare Contribution, on net investment income of a taxpayer earning over \$200,000 (\$250,000 for a joint return). "Net Investment Income" is defined as interest, dividends, royalties, capital gains, annuities, and rents, other than such income that is derived from a trade or business and not treated as passive activity. Net investment income would be reduced by properly allocable deductions to such income.

NEW LIMIT ON HEALTH FLEXIBLE SPENDING ARRANGEMENTS (FSA) CONTRIBUTIONS

The Act

Beginning with years after 2010, the Act imposes a limit of \$2,500 per taxable year on employee salary reductions for coverage under a Cafeteria Plan (FSA). The limit, which does not apply to health reimbursement arrangements, is indexed for inflation based on CPI-U after 2011. If a Cafeteria Plan does not contain the required limitation, then benefits from the FSA will not be qualified benefits.

The Reconciliation

The Reconciliation delays the annual \$2,500 limitation on contributions to a FSA by two years. The limitation would then take effect beginning with years after 2012. The limit would be indexed for inflation based on CPI-U after 2013.

INCREASED TAX ON NON-QUALIFYING HSA OR ARCHER MSA DISTRIBUTIONS

The Act

The tax for HSA withdrawals prior to age 65 that are used for purposes other than qualified medical expenses would be increased from 10% to 20%, and the additional tax for Archer MSA withdrawals that are used for purposes other than qualified medical expenses would be increased from 15% to 20%, both effective for distributions made after December 31, 2010.

The Reconciliation

This provision is unaffected by the Reconciliation.

MODIFIED THRESHOLD FOR CLAIMING MEDICAL EXPENSE DEDUCTIONS

The Act

For tax years beginning after December 31, 2012, the Act would increase the "Adjusted Gross Income" (AGI) threshold for claiming the itemized deduction for medical expenses from 7.5% to 10%. However, the 7.5% of AGI threshold would continue to apply through 2016 for individuals age 65 years and older (including their spouses).

The Reconciliation

This provision is unaffected by the Reconciliation.

DEDUCTION FOR EMPLOYER PART D—ELIMINATED

The Act

The Act would eliminate the deduction for the subsidy for employers who maintain prescription drug plans for their Medicare Part D eligible retirees. This would apply for tax years beginning after December 31, 2012.

The Reconciliation

This provision is unaffected by the Reconciliation.

TAX CHANGES RELATING TO UNIVERSAL HEALTH COVERAGE MANDATE—PENALTY FOR REMAINING UNINSURED

The Act

The Act generally requires that all individuals either obtain health insurance or pay a penalty on their federal tax return beginning in 2014. The amount of the penalty on individuals who choose to remain uninsured would be phased-in and would ultimately reach the greater of \$750 or 2.0% of income for 2016 and subsequent years. An individual must pay the applicable penalty for himself and each of his dependents lacking minimum essential coverage.

The Reconciliation

The Reconciliation would exempt income below the filing threshold, lower the flat payments required from \$750 to \$695 in 2016, and would increase the percent-of-income thresholds. The Reconciliation would extend the exclusion from gross income for employer-provided health coverage for adult children up to age 26. It also would allow self-employed individuals to deduct the cost of coverage for adult children up to age 26.

REFUNDABLE HEALTH CARE PREMIUM TAX CREDIT

The Act

The Act provides a new refundable health care premium tax credit to assist individuals and families who purchase health care on the individual market, including those who obtain coverage through the health insurance exchange established by this Act. The credit, which the U.S. Treasury can distribute as an advance payment, is provided for single or joint filers on a sliding scale for taxpayers whose household income falls between 100% and not more than 400% of the poverty line as determined by family size. The actual amount of the credit is calculated on the basis of identifiable standard monthly premiums, the taxpayer's household modified adjusted gross income, and the number of months during which the taxpayer is insured. Taxpayers eligible for the credit are U.S. citizens and aliens lawfully present in the U.S. who meet income requirements. The credit will be available for taxable years ending after December 31, 2013.

The Reconciliation

The Reconciliation alters the formula used to determine the amount of the tax credits in order to make premiums more affordable. Additionally, starting in 2019, the Reconciliation limits growth of tax credits if premiums are growing faster than the Consumer Price Index, unless spending is more than 10% below current Congressional Budget Office projections.

EMPLOYER PENALTY

The Act

Beginning in 2014, the Act imposes a penalty on employers with 50 or more full-time equivalent (FTE) employees (those working 30 or more hours per week) who are not providing health coverage for their employees. Whether an employer exceeds the 50 FTE employee threshold is generally determined by reference to the average number of employees during the preceding calendar year, with special rules for an employer's first year of business and employers with seasonal workforces.

The penalty for failing to offer health coverage applies if any of an employer's FTE employees become entitled to a tax credit. The penalty is equal to \$750 multiplied by the total number of FTE employees. Beginning in 2015, this amount will be indexed for medical inflation based on the per capita increase in health insurance premiums in the United States.

The Reconciliation

The Reconciliation modifies the Act by dropping the first 30 FTE employees from the payment calculation. It also changes the applicable payment amount for firms with at least 50 FTE employees that do not offer coverage to \$2,000 per FTE employee.

TAX CREDITS FOR SMALL EMPLOYERS OFFERING HEALTH COVERAGE

The Act

The Act provides an immediate sliding scale tax credit up to 35% to small employers (employers with fewer than 25 employees and average annual wages of less than \$50,000) who offer health insurance coverage to their employees. In 2014 and thereafter, eligible small employers who purchase coverage through the Insurance Exchange would be eligible for a tax credit for two years of up to 50% of their contribution.

The Reconciliation

This provision is unaffected by the Reconciliation.

NEW EMPLOYER REPORTING REQUIREMENTS

- For tax years beginning after December 31, 2010, employers would have to disclose the value of the benefit provided by them for each employee's health insurance coverage on the employee's annual Form W-2.
- Insurers (including employers who self-insure and governmental units) who provide the minimum essential health coverage to an individual during each calendar year must report certain information to the covered individual and the Treasury Secretary.
- Any large employer subject to rules for maintaining minimum essential coverage, must file a return that identifies the employer; certifies whether it offers to its full-time employees the option to enroll in a minimum essential coverage plan; and, provides the number of full-time employees during each month of the calendar year and information identifying each full-time employee covered under the employer-provided health plan.

INDUSTRY-SPECIFIC REVENUE RAISERS

- A new deduction limit on executive compensation would apply to insurance providers.
- Pharmaceutical manufacturers and importers would have to pay an annual flat fee beginning in 2011 allocated across the industry according to market share.
- Manufacturers or importers of medical devices would have to pay 2.3% of the sale price. It is imposed on the sale of any taxable medical device by the manufacturer, producer, or importer of the device.
- Health insurance providers would face an annual flat fee on the health insurance sector effective for calendar years beginning after December 31, 2013.
- The indoor tanning industry would be hit with a 10% excise tax on indoor tanning services, effective for services provided on or after July 1, 2010.
- Non-profit Blue Cross/Blue Shield organizations would have to maintain a medical loss ratio of 85% or higher in order to take advantage of the special tax benefits provided to them, including the deduction for 25% of claims and expenses and the 100% deduction for unearned premium reserves. The provision is effective in 2010.

NON-HEALTH RELATED REVENUE RAISERS

- **Corporate Information Reporting.** Businesses that pay any amount greater than \$600 during the year to corporate providers of property and services would have to file an Information Report with each provider and with IRS, effective for payments made after December 31, 2011.
- Codification of economic substance doctrine and imposition of penalties.
- Elimination of credit for "black liquor."
- **Estimated Taxes for Large Corporations.** The Act would increase by 15.75 percentage points the required corporate estimated tax payments factor for corporations with assets of at least \$1 million for payments due in July, August, and September of 2014.

OTHER TAX CHANGES

- **Simple Cafeteria Plans for Small Businesses.** For tax years beginning after 2010, the Act would establish a new employee benefit Cafeteria Plan to be known as a Simple Cafeteria Plan. This plan would be subject to eased participation restrictions so that small businesses could provide tax-free benefits to their employees; it would include self-employed individuals as qualified employees.
- **Liberalized Adoption Credit and Adoption Assistance Rules.** For tax years beginning after December 31, 2009, the Act would increase the adoption tax credit by \$1,000, make the credit refundable, and extend the credit through 2011. The adoption assistance exclusion also would be increased by \$1,000.
- **New Credit for New Therapies.** Effective for expenses paid or incurred after December 31, 2008, in tax years beginning after that date, a two-year temporary credit would be created, subject to an overall cap of \$1 billion, to encourage investments in new therapies to prevent, diagnose, and treat acute and chronic diseases.
- **New Exclusion for Certain Health Professionals.** The Act would exclude from gross income payments made under any State loan repayment or loan forgiveness program that is intended to provide for the increased availability of health care services in underserved or health professional shortage areas. This would be effective for amounts received by an individual in tax years beginning after December 31, 2008. (A separate provision would exclude from gross income the value of specified Indian Tribal Health Benefits, effective for benefits and coverage provided after the enactment date.)

Talk to Us

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