

Tax Aspects of **HEALTH CARE REFORM**

The recent landmark legislation passed by Congress along partisan lines and signed into law on March 23, 2010 is known as the Health Reform Law.ⁱ However, it does not in fact reform the health care system, nor does it protect patients or make health care itself more affordable to U.S. citizens. Instead, it has created a complex and far-reaching system of tax incentives and penalties that affect individuals, businesses and group health insurance companies in order to extend health insurance coverage to more people.

The Health Reform Law contains no major tax increases before 2013, and many of its more controversial provisions also do not take effect for several years. However, there are a few tax relief provisions beginning in 2010, and some provisions are even retroactive for 2009.

A central feature of the Health Reform Law is the creation of health insurance exchanges by 2014. A health insurance exchange is a federally supervised marketplace for health insurance policies meeting specific eligibility and benefit criteria that will be available to qualifying individuals and employer groups of graduated sizes. The cost of a policy through an exchange would be subsidized for individuals and families with incomes up to 400% of the poverty level. It is estimated that about 25 million people or more will take advantage of the insurance exchanges to obtain subsidized health insurance by 2019. The funds for the payment of health insurance for these lower income families will come primarily from penalties on large employers who fail to provide health insurance, penalties on wealthy individuals who choose not to acquire health insurance and an excise tax on high-cost health insurance plans offered by employers.

This article highlights the major components of the recent legislation as they take effect.

RETROACTIVE TO 2009

Student loans. Students may exclude from their income any payments received under a loan repayment of loan forgiveness program that is intended to provide for the increased availability of health care services in underserved areas.ⁱⁱ

EFFECTIVE 2010

Expanded dependent coverage. Group Health insurance plans that provide coverage to dependent children will be required to make coverage available for an adult child until age 26. This requirement is effective for insurance plan years beginning on or after September 23, 2010. This coverage is required regardless of the child's financial dependence, residency with the employee, student status, or employment. It also applies regardless of the child's marital status, but the insurer is not required to cover the spouse of an eligible child.ⁱⁱⁱ In addition to the requirement that coverage be made available until age 26, employees can exclude from income any employer reimbursements for medical care for their adult children until age 27. These exclusions are effective March 30, 2010.^{iv} By virtue of these provisions, insurance plans must make insurance coverage available until a child attains age 26. However, if the plan permits optional coverage that extends beyond the

26th birthday, the value of the coverage can continue to be excluded from the employee's income for the remaining tax year, until the child attains age 27.

Adoption assistance. Tax incentives for adoption have been extended through 2011, and the ceiling on the adoption credit and the income tax exclusion for employer provided adoption assistance has been increased to \$13,170. For 2011, the amount will be indexed for inflation.^v

Medicare drug coverage. Seniors on Medicare Part D prescription drug coverage must pay 100% of the cost of their prescription drugs when the costs exceed \$2,830. Coinsurance does not begin until out-of-pocket costs have exceeded \$6,440. This gap in coverage is known as the "donut hole." In 2010, seniors in the donut hole will receive a credit of \$250. Beginning in 2011, those seniors will be entitled to a 50% discount on the cost of brand name drugs. Over the course of 10 years, the donut hole will eventually close.

Small employer health insurance credit. A business with 10 or fewer full-time employees whose average yearly wages are less than \$25,000 may claim a tax credit of up to 35% of the cost of group health care premiums, so long as the business contributes at least 50% toward the cost of the premiums. A business with up to 25 employees, whose average annual wages are less than \$50,000, may claim a pro-rated credit. Partners, proprietors, 2% owners of S corporations and 5% owners of C corporations, and their family members are not included in determining the number of workers. In 2014, the maximum credit will increase to 50% for employers purchasing insurance through an insurance exchange. The credit cannot be claimed more than twice after 2010, meaning that 2015 will be the last year for most companies to claim the health insurance credit.^{vi}

Indoor Tanning Salons. Beginning July 1, 2010, indoor tanning services will be subject a new 10% excise tax.^{vii}

EFFECTIVE 2011

Over-the-counter drugs. Individuals with health savings accounts (HSAs) or flex plans will no longer be able to use payouts for over-the-counter medications.^{viii}

Nonqualifying medical distributions. In addition, the penalty will double – from 10% to 20% - for distributions from HSAs made for non-medical costs. The penalty on such distributions from an Archer MSA is increased from 15% to 20% of the disbursed amount.^{ix}

EFFECTIVE 2013

Medicare tax on high-earning workers. For single taxpayers whose wages or self-employed incomes exceed \$200,000 and couples filing jointly whose wages or self-employed income exceed \$250,000, there will be an additional 0.9% surtax for Medicare hospital insurance tax. Thus, an employee's Medicare tax will increase to 2.35% and a self-employed person's Medicare tax will increase to 3.8%. This tax obligation is not shared with the employer, nor is it likely to be withheld from wages.^x

Medicare tax on unearned income. A special 3.8% Medicare tax on unearned income will also apply to singles with adjusted gross income (AGI) over \$200,000 and joint filers with AGI over \$250,000. This tax applies to interest, dividends, capital gains, annuities, royalties and passive rental income.^{xi}

Threshold for medical expenses. The current 7.5% of AGI floor for deducting medical expenses will increase to 10%. However, taxpayers who are age 65 and older defer this increase until 2017.^{xii}

Contributions to health FSAs. Contributions to flexible spending accounts for health care costs will be limited to \$2,500 per year.^{xiii}

EFFECTIVE 2014

Individuals without health insurance. Individuals who have no health insurance will pay a penalty tax of the greater of \$95 or 1% of income above the amount of income required to file a tax return. This penalty is capped at \$285. Families will pay a penalty of \$95 per uninsured adult and \$47.50 for every uninsured person under age 18. In 2015, the penalty increases to \$325 per person or 2% of income above the filing threshold, to a maximum of \$975. In 2016, the maximum penalty rises to \$2,085, and after 2016, it is indexed for inflation. Certain lower-income individuals are excepted from this penalty.^{xiv}

Lower-income families buying health insurance. If household income is between 100% and 400% of the federal poverty level, a refundable tax credit in an amount linked to income (the “premium assistance credit”) will be paid to an exchange to apply toward health insurance coverage for the household. This tax credit will be available to singles with a household income of \$11,000 to \$44,000, and a family of four with an income between \$22,000 and \$88,000.^{xv}

“Free choice” vouchers for basic coverage. Employers that offer minimum essential coverage through an employer-sponsored medical plan and pay a portion of that coverage must provide eligible employees with a “free choice” voucher that can be applied to purchase health insurance through an exchange. An eligible employee is one who does not participate in the employer-sponsored plan and who falls into a category of lower-income workers.^{xvi}

Larger employers without affordable health insurance. Businesses with 50 or more full-time employees that have no health plan will owe an excise tax, if even one employee who is eligible for a credit for health insurance coverage purchases insurance through an exchange. The non-deductible excise tax will be \$2,000 times the total number of employees, with an offset of \$60,000. Businesses that offer group health insurance, but have lower-income workers, will also pay an excise tax of \$3,000 per year for each lower-income employee who elects to purchase insurance through an exchange instead of using the employer’s plan.^{xvii}

EFFECTIVE 2018

High-cost health insurance. Insurance companies and self-insured companies will pay a 40% excise tax on the value of their health insurance plans in excess of \$10,200 per year for individual coverage and \$27,500 per year for family coverage. The thresholds are higher for retirees over age 55 and employees having high-risk jobs, such as police and firefighters. Dental and vision coverage are not included in determining a plan’s value.^{xviii}

Because the effective dates of various provisions of the Health Reform Law are spread over several years, there will be changes each year. The major change occurs in 2014 with the creation of health insurance exchanges, which are expected to provide affordable health insurance to lower-income families. If more families have health insurance, the expectation is that health care costs will be controlled and quality health care will be provided. The next legislative task will be to effectively regulate the health insurance industry.

ⁱ The Patient Protection and Affordable Care Act (Health Care Act, H. R. 3590, P.L. 111-148) and the Health Care and Education Reconciliation Act of 2010 (Reconciliation Act, H.R. 4872).

ⁱⁱ Internal Revenue Code (“IRS”) §108(f)(4).

ⁱⁱⁱ Added Public Health Service Act §2714, incorporated into IRC §9815.

^{iv} IRC §§105(b), 401(h), 501(c)(9) and 162(l).

^v IRC §§137, 162(l)(1)(D).

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- vi IRC§45R.
 - vii IRC§5000B(a).
 - viii IRC§§106(f),220(d)(2)(A), 223(D)(2)(A).
 - ix IRC§§220(f)(4)(A), 223(f)(4)(A).
 - x IRC§§1401(b)(2), 3101(b)(2), 6051(a)(14).
 - xi IRC§1411.
 - xii IRC§§213(a), 213(f)
 - xiii IRC§125(i)
 - xiv IRC§5000A.
 - xv IRC§36B.
 - xvi IRC§§139D,162(a).
 - xvii IRC§4980H.
 - xviii IRC§4980I.