



## 2009 HEALTH CARE REFORM

### Special Report

#### HIGHLIGHTS:

- ✓ *Required Individual Coverage*
- ✓ *Affordability Credits*
- ✓ *Enhanced Employer Responsibility*
- ✓ *Small Business Tax Credits*
- ✓ *Higher-Income Surtax*
- ✓ *Tax On High-Cost Insurance*
- ✓ *New Caps On FSAs*
- ✓ *Economic Substance Codification*

## House Passes Higher-Income Surtax, New Limits On FSAs, and More To Fund Health Care Reform

Health care reform took a major step forward late on November 7 when the House passed, 220-215, a mammoth 2,000+ page bill overhauling health insurance coverage for Americans. The Affordable Health Care for America Act (H.R. 3962) imposes a new surtax on higher-income individuals expected to raise more than \$400 billion over 10 years to help pay for nearly universal coverage. The Act also places new limits on health flexible spending accounts, higher penalties on nonqualified distributions from health savings accounts, and an excise tax on medical devices. In looking for ways to cover the huge price tag for health reform, the Act also makes significant changes to areas of the tax law unrelated to health care except in their common ability to raise revenues. In addition to the surtax on high-income individuals, these tax increases include tightened treaty benefit limitations, new information reporting requirements on payments to corporations, extended repeal of worldwide interest allocation, new restrictions on the biofuel producers' credit, and codification of a broad economic substance doctrine.

*to health insurers and, to a lesser extent, pharmaceutical companies and medical equipment providers to share in the costs of reform. All of these "revenue-related" components, as well as other ways to pay for the bill, will form a major part of the debate before a final bill comes to a vote.*

**Comment** As expected, the Act passed the House along party lines with only one GOP member supporting the bill. The House vote is expected to put pressure on Senate leaders to finalize their version of health care reform. Senate Democrats are struggling to blend two versions of health care reform: one bill passed by the Senate Finance Committee (SFC) and another passed by the Senate Health, Education, Labor, and Pensions (HELP) Committee. The SFC bill is the only Senate version that includes a revenue raiser comparable in price tag to the House's surtax. The SFC bill would impose a new excise tax on high-dollar health insurance plans.

**Impact** *The Tax Code plays a critical role in promoting health reform's core concepts. On the one hand, it provides tax incentives and penalties to channel behavior; on the other hand, it raises a significant portion of the revenues Congress needs to implement its reform measures. In addition, the government is looking*

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#### CORE CONCEPTS

Although many details still need to be worked out before Congress passes a final bill, the core concepts that are emerging would fundamentally alter the health care landscape.

**First.** All individuals would be required to obtain health care coverage. Employer-provided coverage would generally satisfy the universal-coverage requirement. Individuals without employer-provided coverage would be allowed to shop among private insurers and a “Health Insurance Exchange.” Individuals who do not obtain qualifying coverage would be subject to a penalty. Low-income individuals would receive a credit or voucher to help pay for health insurance.

**Second.** Employers currently offering health insurance could elect to continue offering coverage so long as their plans meet certain acceptable minimum requirements. Employers electing not to offer qualifying coverage would be subject to an additional payroll tax to help finance the health care coverage for their employees. Exceptions would be made for small businesses.

**Comment** The IRS would be responsible for overseeing a large part of health care reform. SFC ranking member Charles Grassley, R-Iowa, recently asked Treasury Department for details on how the IRS would implement some of the measures in the pending health care reform legislation. IRS Commissioner Douglas Shulman declined to provide details but said that the IRS would be ready to implement its responsibilities.

## INDIVIDUAL COVERAGE

Under the House-passed Health Care Act, individuals without acceptable health care coverage would pay an additional tax. The additional tax to enforce the so-called “individual mandate” could equal as much as 2.5 percent of the taxpayer’s modified adjusted gross income (AGI) that exceeds the taxpayer’s applicable exemption amount plus the standard deduction for the year. The additional tax would be in addition to both the regular income tax and the alternative minimum tax (AMT). The additional tax would not be allowed to

exceed the applicable national average premium for the tax year.

The House-approved version of health care reform provides low-income individuals with “affordability credits” to help pay for the cost of coverage purchased through the exchange. The credits would be available on a sliding scale linked to the federal poverty limit. For example, a family of four earning up to \$88,000 would be entitled to a subsidy.

**“The Tax Code plays a critical role in promoting health reform’s core concepts.”**

The House’s Health Care Act also creates a reinsurance program for employer-sponsored retiree coverage. Payments made under the reinsurance program for retirees would be excluded from gross income. Additionally, health services provided or purchased by the Indian Health Service would be expressly excluded from gross income.

**Impact** *The additional tax would not apply to any individual properly claimed as a dependent. However, parents or guardians claiming qualified children as dependents would be required to maintain health care coverage for them. Parents can also choose to keep their children age 26 and under on their insurance policy.*

**Comment** Individuals with Medicare, Medicaid, VA or other government-sponsored coverage would be treated as having acceptable coverage. The Health Care Act includes a religious objection provision.

**Comment** As passed by the House, the Health Care Act limits out-of-pocket costs to no more than

\$500 for an individual and \$1,000 for a family at the lowest income levels. The out-of-pocket limits rise to \$5,000 for an individual and \$10,000 for a family at the highest income tier for individuals receiving affordability credits.

**Senate.** Under the SFC proposal, individuals without qualifying coverage would pay an annual nonrefundable excise tax. Depending on income, the excise tax would start at \$200 per year for individuals in 2014 and climb to \$750 per year for individuals by 2017. The Senate HELP Committee would impose a similar penalty; generally remaining fixed at \$750 per year for an individual without coverage, with a maximum \$3,000 penalty for a family of four. The SFC and Senate HELP bills also include a reinsurance program for employer-provided retiree coverage.

**Comment** Under the SFC bill, children enrolled in the Children’s Health Insurance Program (CHIP) would be exempt from the individual mandate.

## EMPLOYERS

The Health Care Act, as passed by the House, requires employers to satisfy certain minimum coverage requirements. Generally, the “employer mandate” requires employers to contribute at least 72.5 percent of premium costs for individuals and 65 percent of premium costs for families. Employers that elect not to offer qualified coverage to their employees would be liable for an additional payroll tax of up to eight percent of the employee’s average annual salary. Small employers (generally employers with annual payrolls below \$500,000) would be exempt from the additional payroll tax. A graduated additional payroll tax (starting at two percent and rising to six percent) would apply to employers with annual payrolls between \$500,000 and \$750,000.

**Comment** The FICA concept of “wages” would be used to compute the additional tax (except that there would be no annual taxable wage base). Annual payroll means the aggregate wages paid by the employer during the calendar year.

**Senate.** The SFC bill does not mandate employer coverage. But under its “play-or-pay” strategy, employers with more than 50 employees that do not offer coverage would be assessed a fee for each full-time employee who secures individual coverage. Generally, the maximum fee would be \$400 per employee or an amount determined by the U.S. Department of Health and Human Services. Additionally, employers with 200 or more employees would be required to automatically enroll employees into their health insurance plans. Employees would be able to opt-out of automatic enrollment if they can show other qualifying coverage.

The Senate HELP Committee, on the other hand, would impose a blanket \$750 annual fee per full-time employee and \$375 for each part-time employee (exempting the first 25 employees) on employers who choose to “pay” instead of “play.”

## SMALL BUSINESSES

The House-approved Health Care Act provides a temporary credit for up to 50 percent of qualified health coverage expenses for the tax year for qualified small employers. The credit phases out for employers with average annual wages of \$20,000 to \$40,000 and also for small employers with 10 to 25 employees. The credit is part of the general business credit.

**Comment** No credit is allowed with respect to highly-compensated employees, which the House-passed Act defines as individuals with annual compensation of \$80,000 or more.

**Senate.** The SFC bill provides tax credits to small businesses with fewer than 25 employees to help offset the cost of offering health insurance to employees. In certain cases, hours worked by seasonal employees would be excluded from computation for the credit. Tax-exempt employers would get a reduced credit.

The Senate HELP Committee bill targets tax credits to employers with 50 or fewer full-time employees and that pay 60 percent or more of their employee’s health insurance premiums. Credits would be available for up to three consecutive years.

**“The IRS would be responsible for overseeing a large part of health care reform.”**

## SURTAX

The Health Care Act, as passed by the House, imposes a surtax of 5.4 percent on married couples filing jointly and surviving spouses with modified AGI that exceeds \$1 million. The same 5.4 percent rate would apply to other taxpayers with modified AGI exceeding \$500,000, including estates and trusts. The surtax is estimated to raise \$460.5 billion over 10 years. An increasing number of taxpayers are expected to be subject to the surtax over time.

**Impact** *The surtax is not indexed for inflation. Consequently, taxpayers would be vulnerable to “surtax creep.” As incomes rise in response to inflationary pressures, more individuals and families below the current thresholds will be liable for the surtax. The surtax, however, has little support in the Senate and could be scaled back in a final bill.*

**Impact** *The health care surtax kicks in at the same time as anticipated increases in the top marginal income tax rates for individuals. President Obama has proposed raising the top two marginal rates to 36 percent and 39.6 percent, starting in 2011. This increase, which would operate independently of any health care surtax, would affect individuals with incomes of more than \$200,000 (\$250,000 for married couples filing jointly).*

The surtax would apply to tax years beginning after December 31, 2010. Modified AGI for purposes of the surtax means AGI reduced by the deduction for investment interest.

**Senate.** The SFC and Senate HELP Committee bills do not include the higher-income individuals’ surtax. Such a provision is perceived as taking away a critical number from the 60 votes needed in the Senate to pass health care reform outside of the budget reconciliation process. Instead, the Senate’s principal revenue raiser taxes high-cost health care policies, so-called “Cadillac plans,” at the insurer level.

## TAX ON HIGH-COST INSURANCE

**Senate.** The SFC bill would impose a 40 percent nonrefundable excise tax on group insurers if the aggregate value of employer-provided health coverage exceeds \$8,000 for individual coverage and \$21,000 for family coverage. Designed principally to limit so-called “Cadillac plans,” the excise tax for these high-end policies would be imposed *pro rata* on issuers. For self-insured plans, the plan administrator (including employers that act as plan administrators) would pay the excise tax. Transition relief would be available for coverage in high-cost states. The threshold amounts would be indexed for inflation. The excise tax is estimated to generate approximately

\$200 billion over 10 years but would not take effect until 2013.

The SFC bill would require employers to disclose the value of employer-provided health insurance to employees annually on Form W-2 for tax years beginning after December 31, 2009.

**Impact** *Some taxpayers would be insulated from the excise tax. Under the SFC bill, the thresholds would be \$9,850 for single coverage and \$26,000 for family coverage for high-risk jobs such as law enforcement personnel, fire fighters and other first responders, as well as individuals in high-risk occupations, such as mining. Retired individuals age 55 and older would also be eligible for the higher thresholds.*

**Example** *Abby, age 36, elects family coverage under an employer-provided fully-insured health care policy covering major medical and dental with a value of \$28,000. The amount subject to the proposed excise tax would be the \$7,000 above the \$21,000 threshold for family coverage. Abby's employer would report \$7,000 as taxable to the insurer. The insurer calculates and pays the tax to the IRS.*

**Comment** The SFC bill would also exclude fixed indemnity health plans purchased with after-tax dollars from the excise tax. These are

employee-paid plans that pay a fixed dollar amount for certain medical procedures and/or hospitalization.

**Impact** *An insurer would be free to pass along the excise tax to consumers in the form of higher premiums as an alternative to, or in combination with, finding cost-cutting opportunities.*

**Comment** The SFC bill, but not the House's Health Care Act, includes limits on the deductibility of executive compensation by insurance providers.

## FSA's

The Health Care Act, as passed by the House, prohibits taxpayers from using health FSA dollars to pay for over-the-counter medications (unless prescribed by a health professional). The Health Care Act and the SFC bill would also cap annual contributions to a health FSA offered under an employer-sponsored cafeteria plan at \$2,500. The \$2,500 threshold would be indexed for inflation

**Comment** The House's Health Care Act expressly includes insulin as a covered expenditure.

**Senate.** The SFC bill generally tracks the Health Care Act

**Comment** The House-approved Health Care Act and the

SFC bill would also extend to health savings accounts (HSAs), health reimbursement arrangements (HRAs) and Archer Medical Savings Accounts (Archer MSAs). The dollar limits on HSAs may be higher in any final bill to fully cover, pre-tax, the high-deductible requirements for using HSAs.

## HSAs

Generally, the House-passed Health Care Act provides that individuals under age 65 must pay an additional tax for unqualified distributions from a health savings account (HSA) and increases the additional tax from 10 percent to 20 percent.

**Senate.** The SFC bill generally tracks the Health Care Act.

## MEDICAL EXPENSE DEDUCTION

**Senate.** The SFC bill raises the threshold for the itemized medical expense deduction from 7.5 percent of adjusted gross income (AGI) to 10 percent of AGI for regular income tax purposes. However, individuals age 65 and older (and their spouses) would be exempt from the increase. The House did not include this cutback to the medical expense deduction.

**Comment** The exemption for senior citizens would sunset after December 31, 2016.

## EXCLUSION

The House-approved Health Care Act extends the exclusion from gross income for employer-provided health coverage for employees' spouses and dependent children to coverage provided to domestic partners

**Impact** Domestic partners are not treated as spouses for

PROPOSED SURTAX		
Taxpayer	Modified Adjusted Gross Income (AGI) Level	Surtax Rate
Joint filers Surviving spouses	Over \$1 million	5.4%
Single Filers Head of Household Married Filing Separately Estates and Trusts	Over \$500,000	5.4%

federal tax purposes. Consequently, an employee currently pays tax on the fair market value of the cost of coverage for the employee's domestic partner.

**Senate.** The SFC bill does not include a similar provision.

## MARKET SECTOR FEES

**Senate.** The SFC bill imposes annual nondeductible fees on various health-related industries over 10 years. The annual fees would be allocated across industry sectors according to market share. The annual fees would be: \$2.3 billion on manufacturers and importers of branded drugs; \$4 billion on manufacturers and importers of medical devices; and \$6 billion on health insurance providers.

**Comment** The SFC bill includes a new tax credit for industries that invest in chronic disease therapies.

The SFC bill would also require 501(c)(3) hospitals to conduct periodic community health needs assessments and adopt written financial assistance policies. Individuals who qualify for financial assistance would be billed at the same rates as insured individuals. The SFC bill would also add some consumer protection provisions to debt collection activities by nonprofit hospitals.

**Comment** The IRS would be required to review a nonprofit hospital's community benefit activities at least once every three years.

The House's Health Care Act does not include market sector fees. However, it imposes a new 2.5 percent excise tax on certain medical devices. The excise tax would attach at the time of the first taxable sale of the medical device.

## RETIREE PRESCRIPTION DRUG SUBSIDY

The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 created a retiree drug subsidy program to encourage employers to provide prescription drug coverage to their retirees. Employers receive a tax-favored subsidy. The subsidy, which is excluded from an employer's income, is equal to 28 percent of the allowable costs, including administrative costs, attributable to covered prescription drug costs incurred by a qualifying retiree of between \$295 and \$6,000 in 2009. The House's Health Care Act and the SFC bill eliminate the exclusion, as well as deny businesses a deduction for related federal subsidies starting in 2013.

## CAFETERIA PLANS

Under the House-approved Health Care Act, coverage purchased through the exchange could not be purchased on a pre-tax salary reduction basis.

**Senate.** In the only tax cut (\$4 billion) in its tax title, the SFC bill would relax the cafeteria plan rules to encourage more small employers to offer tax-free benefits to employees, including those related to health insurance coverage. Additionally, there would be a safe harbor from the nondiscrimination requirements for cafeteria plans for qualified small employers.

## COBRA

The House's Health Care Act permits COBRA eligible individuals to continue their COBRA coverage until they secure coverage through a new employer or the exchange.

**Comment** The Health Care Act, as passed by the House, does not extend temporary COBRA premium assistance under the American Recovery and Reinvestment Act of 2009.

**Senate.** The SFC bill does not include a similar provision.

## ECONOMIC SUBSTANCE DOCTRINE

The House-approved Health Care Act codifies the economic substance doctrine. A transaction would have economic substance only if the taxpayer's economic position (other than its federal tax position) changed in a meaningful way and the taxpayer had a substantial purpose (other than a federal tax purpose) for engaging in the transaction

**Impact** Violations are subject to stiff, automatically-applied penalties of 20 or 40 percent, depending on the underlying transaction. This no-fault penalty regime concerns many advisors, especially in connection with corporate and partnership tax planning strategies in which tax avoidance in the form of tax reduction has been an acceptable principal reason for structuring certain deals.

**Senate.** The SFC and Senate HELP Committee bills do not codify the economic substance doctrine. Nevertheless, with White House endorsement of codification early this year, along with the projected \$8.5 billion in revenue that penalties would raise, most tax practitioners are resigned to its passage, either in a final health care bill negotiated in the conference between House and Senate designees or in another tax bill now in the queue.

## WORLDWIDE INTEREST

The American Jobs Creation Act of 2004 allowed a worldwide affiliated group to make a one-time election to determine the foreign source taxable income of the group by allocating and apportioning the domestic members' interest expense on a worldwide basis, as if all members of

the group were a single corporation. The Housing and Economic Recovery Act of 2008 delayed the effective date of the worldwide interest allocation rules until tax years beginning after December 31, 2010, and the Worker, Homeownership, and Business Assistance Act of 2009, signed into law by President Obama on November 6, 2009, delays the effective date of worldwide allocation of interest until tax years beginning after December 31, 2017. The House's Health Care Act would repeal the provision entirely effective for tax years beginning after December 31, 2010.

**Senate.** The SFC and the Senate HELP Committee bills do not repeal worldwide allocation of interest.

## TREATY BENEFITS

The Health Care Act, as passed by the House, includes provisions to prevent foreign multinational corporations from avoiding tax on income earned in the U.S. The Health Care Act targets the practice of having a U.S. subsidiary of the foreign corporation make a deductible payment to a tax treaty jurisdiction before repatriating those earnings.

**Senate.** The SFC and Senate HELP Committee bills do not include a similar provision.

## INFORMATION REPORTING

A trade or business must file an annual information return with respect to certain payments. Taxpayers file a Form 1099-MISC for each person to whom they have paid at least \$600 for services, rents or other income payments. Under current rules, payments to most corporations are exempt. The House-approved Health Care Act eliminates the exemption from information reporting by any trade or business for payments to all corporations effective for payments made after December 31, 2011.

**Senate.** The SFC bill includes a similar provision.

## UNDERPAYMENT PENALTIES

The Health Care Act, as passed by the House, requires that certain large or publicly-traded entities, to avoid underpayment penalties, must show that the taxpayer's basis for the underpayment was a reasonable belief that the tax treatment more likely than not is the proper tax treatment.

**Senate.** The SFC and Senate HELP Committee bills do not include a similar provision.

## BIOFUEL CREDIT

The cellulosic biofuel credit was intended to reward taxpayers that use alternative fuels in industrial and other processes. The House-approved Health Care Act targets what some lawmakers perceive as an abuse of the credit by certain industries by denying the credit to a by-product known as "black liquor."

**Senate.** The SFC and Senate HELP Committee bills do not include a similar provision.

## MORE PENDING LEGISLATION

**Extenders.** Every year, Congress extends a package of popular but temporary tax breaks known as "extenders." These include the state and local sales tax deduction, the teachers' classroom expense deduction, the higher education tuition deduction, the Indian employment credit, brownfields remediation, and more. Unless extended, many of these incentives will expire at year-end 2009.

**Comment** One stumbling block to passage of the extenders

is whether to offset them with revenue raisers. It is unclear at this time if the extenders could move in the House if they are not offset. If not passed by year end, Congress could still extend these provisions retroactively next year.

**AMT patch.** The Emergency Economic Stabilization Act of 2008 (EESA) temporarily "patched" the AMT by raising the exemption amounts and allowing taxpayers to take nonrefundable personal credits to reduce AMT liability. The AMT "patch," however, is for 2009 only. Consensus is growing in Congress to defer addressing this expensive measure until early next year, when it would be made effective retroactively for the entire 2010 tax year.

**COBRA premium assistance.** Individuals involuntarily separated from employment through December 31, 2009 may elect to pay 35 percent of their COBRA coverage and be treated as paying 100 percent. The federal government reimburses employers for their 65 percent portion of the premium through a temporary payroll tax credit. Pending legislation would extend COBRA premium assistance for an additional 12 months.

**Estate tax reform.** Under 2001 legislation, the estate tax is scheduled to be completely repealed in 2010, only to return at pre-2001 levels in 2011. Congress is expected to address the estate tax before year-end but leaders are struggling over when to work this "must pass" legislation into the calendar for a vote.

**Comment** The Estate Tax Relief Act of 2009 (H.R. 3905) would gradually increase the current exemption from \$3.5 million to \$5 million by 2019 and index it for inflation. The bill would also reduce the estate tax rate from 45 percent to 35 percent over the same 10-year period.

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