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## TAX PROVISIONS IN HEALTHCARE REFORM LEGISLATION

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The recent legislative overhaul of the healthcare insurance industry presents many tax issues relevant to individuals and businesses. Some of the more salient provisions of the newly enacted legislation are briefly discussed in this alert.

### **MEDICARE TAX INCREASE FOR HIGH-EARNED-INCOME TAXPAYERS**

For taxpayers earning wages or self-employment income in excess of \$200,000 (\$250,000 for joint filers and \$125,000 for a married taxpayer filing a separate return), the Medicare tax will increase from 2.9% to 3.8%. This tax is currently split evenly between employer and employee. Self-employed taxpayers must pay the whole tax but may deduct what would otherwise be the employer's share (1.45%). The increase in the tax rate will be borne totally by the "employee's portion" of the tax liability. Thus, for example, a single taxpayer earning wages in excess of \$200,000 will pay 2.35% in Medicare taxes on the wages he or she earns in excess of \$200,000 while his or her employer will pick up the remaining 1.45%. Similarly, a self-employed individual will only be permitted a deduction for 1.45% of the tax. The change will take effect for taxable years beginning in 2013. Significantly, the income thresholds are not indexed for inflation; thus, the scope of this tax increase will broaden over time.

### **MEDICARE TAX INCREASE ON CERTAIN NET INVESTMENT INCOME**

Effective for tax years beginning in 2013, the 3.8% Medicare tax will apply, for the first time, to certain net investment income of individuals, estates, and trusts. Individuals will be subject to the tax only to the extent modified adjusted gross income exceeds the thresholds set forth directly above. "Net investment income" is rather broadly defined to include many types of

investment income (reduced by deductions allocable to that income), such as dividends, interest (but not tax-exempt interest), rents, royalties, gross income from a trade or business, and net gain from the disposition of property. The tax does not apply to income in tax-deferred plans, such as 401(k) plans. Special rules apply to gain from the disposition of interests in S corporations and partnerships.

### **CREDIT FOR EMPLOYEE HEALTH INSURANCE EXPENSES**

Beginning in 2010, certain small businesses will be eligible for a nonrefundable credit of up to 35% of the total premium cost of employer-provided health insurance. The credit will increase to 50% of the total premium cost for tax years beginning after 2013, but this 50% credit may only be used in two tax years. Thus, at most, an employer may only take a credit in six taxable years. To be eligible, an employer must contribute at least 50% of the total per employee premium cost. Through tax years beginning in 2013, employers with fewer than 11 full-time employees, and average annual wages of not more than \$25,000 per employee, will be eligible for the full credit. Those that employ between 11 and 25 employees, with average annual wages between \$25,000 and \$50,000 per employee, are eligible for a reduced credit based on a sliding-scale computation.

### **HEIGHTENED INFORMATION REPORTING REQUIREMENTS**

Currently, taxpayers must complete Form 1099 for each payee receiving compensation or fixed and determinable sums of \$600 or more from the taxpayer's trade or business. Payments to corporations are exempt. For payments made after December 31, 2011 the exemption for payments to corporations is eliminated. Further, gross proceeds paid to a payee in consideration for property or services will be included – along

# TAX PROVISIONS IN HEALTHCARE REFORM LEGISLATION CONTINUED

with compensation and fixed and determinable sums – as a reportable item.

## **COST OF COVERAGE INCLUDED ON W-2**

Effective for tax years beginning after December 31, 2010, employers must include the cost of employer-sponsored healthcare coverage on Form W-2. Contributions to certain Archer Medical Savings Accounts (MSAs), Health Savings Accounts (HSAs) and Flexible Spending Account (FSAs) are excluded.

## **CHANGE IN TREATMENT OF OVER-THE-COUNTER MEDICATIONS**

Effective in 2011, over-the-counter medications are not eligible for tax-free reimbursements from HSAs and Archer MSAs, nor are they eligible for reimbursement through a Health FSA or Health Reimbursement Arrangement. Such plans may only make nontaxable reimbursements for prescription medications and insulin. Further, the tax on non-qualifying distributions from HSAs and Archer MSAs will be increased to 20%. And, beginning in 2013, salary reduction contributions to a Health FSA will be capped at \$2,500 per year (indexed for inflation).

## **SIMPLE CAFETERIA PLANS**

Employers averaging 100 or fewer employees (in either of the two preceding years) will be able to establish “SIMPLE cafeteria plans,” provided certain minimum eligibility, participation, and contribution requirements are met. This provision is effective for plan years starting after December 31, 2010.

## **DEDUCTION FOR SELF-EMPLOYED TAXPAYERS**

Starting April 1, 2010, self-employed taxpayers may deduct medical insurance premiums paid to cover the taxpayer, the taxpayer’s spouse, dependents, and children under age 27.

## **REIMBURSEMENTS UNDER ACCIDENT AND HEALTH PLANS**

Effective immediately, taxpayers will no longer be taxed on reimbursements from employer-provided accident or health plans for medical expenses paid on behalf of their children who are under the age of 27 as of the end of the tax year.

## **NON-DISCRIMINATION PROVISIONS**

Previously, only self-insured medical expense reimbursement plans were subject to provisions aimed at penalizing discrimination in favor of highly-compensated individuals (HCIs). Effective for plan years beginning after September 23, 2010, fully insured health plans will be subject to similar provisions. Where a fully insured plan is discriminatory in favor of HCIs, amounts which constitute excess reimbursement of an

HCI, as defined in the Internal Revenue Code, will constitute income to the recipient. For example, in the case of a benefit available to HCIs but not to all other participants, the full amount reimbursed to the HCI with respect to such benefit will be subject to tax. In other cases, the “excess benefits” are determined using the ratio that total benefits paid to HCIs bears to total benefits paid to all employees.

## **TAX ON “CADILLAC” PLANS**

The new legislation imposes a 40% excise tax on coverage that exceeds \$10,200 for an individual (\$27,500 for families). This provision takes effect in 2018 and the amounts are indexed for inflation. The limits are also adjusted for age, gender, and high-risk professions. The excise tax is imposed on insurance companies and plan administrators.

## **QUALIFYING THERAPEUTIC DISCOVERY PROJECT CREDIT**

This credit is available for taxable years beginning in 2009 or 2010 and is equal to 50% of the aggregate costs (with certain exclusions) directly related to the conduct of a “qualifying therapeutic discovery project” or “QTDP.” QTDPs include certain projects designed to: (1) treat or prevent diseases or conditions through the use of certain trials and studies; (2) diagnose diseases or conditions by developing molecular diagnostics to guide therapeutic decisions; or (3) hone the delivery or administration of therapeutics. The credit is nonrefundable but taxpayers may be able to claim a grant in lieu of the credit. Only taxpayers employing fewer than 251 employees (in all businesses) are eligible for the credit.

## **TAX ON MEDICAL DEVICE INDUSTRY**

The Legislation imposes a 2.3% excise tax on certain medical devices sold in the United States. The provision takes effect in 2013.

## **PRESCRIPTION DRUG INDUSTRY USER FEE**

Beginning in 2011, an annual fee will be imposed on manufacturers and importers of certain branded prescription drugs and biologics for sale to specified government programs, such as (but not limited to) Medicare and Medicaid. This fee is treated as an excise tax and is not deductible for income tax purposes. The aggregate fee imposed on covered manufacturers and importers (which starts at \$2.5 billion in 2011 before climbing to \$4.1 billion in 2018 and settling at \$2.8 billion thereafter) is shared among individual firms based on market share.

## **INCREASED THRESHOLD FOR MEDICAL EXPENSE DEDUCTION**

Effective in 2013, the threshold for claiming itemized medical

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expense deductions is increased to 10% of AGI (from 7.5%).

### **REDUCED DEDUCTION FOR PART D EXPENSES**

Currently, employers providing prescription drug coverage to Medicare Part D-eligible employees/retirees may deduct the entire cost of the coverage, notwithstanding the tax credit they receive (equal to the value of Part D coverage). After 2012, the deduction is reduced to the extent of the credit. In other words, employers will not be able to take a deduction for the portion of the coverage that is subsidized. Incidentally, many companies must write-down any deferred tax asset tied to the future deduction that will no longer be allowed.

### **CODIFICATION OF ECONOMIC SUBSTANCE DOCTRINE**

Essentially, business transactions must (1) change, in a meaningful way, the taxpayer's economic position (unrelated to tax savings); and (2) have a substantial business purpose (again, apart from tax savings). New and more severe penalties will apply to understatements tied to transactions lacking economic substance. There are no exceptions available for this penalty, which can amount to 20% or 40% of the understatement, depending on the circumstances.

If you would like to discuss how any of these changes may affect your business or personal income tax situation, or have any other tax or estate planning questions, please contact Scott Borsack (215.864.7048), Bill Hussey (215.864.6257), or Kevin Koscil (215.864.6827).

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