PUBLICATION

Tax Implications of the 2010 Health Care Laws

July 12, 2012

Now that the Supreme Court has decided, by a 5-4 majority, that the Patient Protection and Affordable Care Act (ACA) will survive its constitutional challenges, taxpayers must ready themselves for a variety of important tax changes made by the ACA and other federal legislation enacted in 2010, some of which are scheduled to be implemented starting January 1, 2013. These changes include a 3.8 percent surcharge on net-investment income for certain wage-earners, a 0.9 percent increase in employment taxes for higher earners and a bevy of new responsibilities and credits for employers. In addition, beginning in 2014 the very controversial shared responsibility payment is scheduled to be implemented -- such payment, recently upheld by the Supreme Court as a constitutional tax, applies to those who wish not to comply with the ACA's Individual Mandate. The following is a brief overview of just some of such tax changes.

3.8 Percent Surtax on Net-Investment Income

In order to help fill any budget gaps caused by the expansion of Medicare, the Health Care and Education Reconciliation Act of 2010 added a 3.8 percent tax on "net-investment income" starting in 2013. Net-investment income includes capital gains, dividends, interest, annuities, royalties and rents (other than rents received in the ordinary course of business).

This tax will only apply to joint filers with income (slightly modified) in excess of a $250,000 threshold and single filers with income exceeding $200,000, beginning in 2013. To the extent the amount of income exceeding the threshold is less than net-investment income, such lesser amount is taxed.

Noticeably missing from the legislation's definition of net-investment income is the cash built-up in life insurance policies, tax-exempt income and earnings within qualified retirement plans. However, distributions from a traditional IRA will contribute to the balance tested against the threshold amounts of $250,000 ($200,000 for single filers), while Roth IRA distributions will not be counted. Therefore, those taxpayers contemplating a rollover of a traditional IRA to a Roth IRA, which is allowed for high-income individuals this year, now have an extra incentive.

0.9 Percent Increase for Certain High-Income Earners

In addition, beginning in 2013, taxpayers may be surprised to learn that if they make more than $200,000 ($250,000 for joint filers), an additional 0.9 percent will be added to the Medicare tax on wages earned. Currently, the taxpayer is required to pay 1.45 percent on the wages earned, while the employer makes a matching contribution. However, for those with wages exceeding the threshold amounts, an additional 0.9 percent tax is added to the employee portion of required contributions.

This is an increase that is seldom mentioned in relation to other tax increases within the ACA, but it will affect many taxpayers over the course of the coming years. Those taxpayers who might be subject to this additional amount of tax may wish to reconsider engaging in deferred compensation plans this year, as well as consider selling non-qualified stock options prior to year-end.

Shared Responsibility Payment

Taxpayers who choose not to comply with the Individual Mandate provisions of the ACA may be required to remit a shared responsibility payment along with their taxes. Individuals who elect not to purchase health insurance for months beginning January 1, 2014, must decide whether the Individual Mandate applies to their personal situation, and then whether they qualify for any exceptions to the payment.

Generally, the Individual Mandate requiring that taxpayers carry at least minimum health insurance coverage applies to all taxpayers who file a return, unless they are members of a religious sect that is recognized as having beliefs in conflict with the Mandate, belong to a health care sharing ministry, are not a citizen or national of the U.S. or an alien lawfully present in the U.S. or are currently incarcerated.

Unless the individual is not required to purchase insurance as described in the preceding paragraph, the individual will be required to pay a penalty for any month in which he or she does not meet the requirements for minimum coverage. That is unless the cost of the required monthly coverage exceeds eight percent of such individual's annual income, the individual is a member of an established Indian tribe, the individual is determined to be under hardship by the Secretary of Health and Human Services or is otherwise legislatively exempted from the payment.

The payment is calculated on a monthly basis as the lesser of 300 percent of the "applicable dollar amounts" or the sum of the "applicable dollar amounts" for all individuals with respect to whom the taxpayer is responsible for who fail to meet the coverage requirements. The applicable dollar amount is phased-in for 2014 and 2015 at $95 and $325, respectively. However, in 2016, the applicable dollar amount stabilizes at $695, indexed for inflation. Further, if the foregoing amounts are less than a stated percentage of income in excess of certain amounts (2.5 percent for years 2015 and beyond), the higher amount will be deemed the penalty owed.

It is important to note that persons listing another individual as a dependent on their return will be responsible for such dependent's payment under the ACA, and joint-filers will be jointly and severally liable for one another under the ACA.

There have been several questions regarding the IRS's ability to enforce the shared responsibility payment. The IRS may not rely on several of the typical means utilized for collections, including the notice of federal tax lien, levies and criminal proceedings. Because the IRS is explicitly disallowed from utilizing these methods for collecting the shared responsibility payment, one of the few remaining viable methods for enforcement is the Service's ability to set-off amounts owed against refundable credits and other refunds due to the taxpayer. Therefore, it may prove difficult for the IRS to collect shared responsibility payments from certain taxpayers who are unwilling to voluntarily comply with the payment and are not otherwise entitled to refunds of taxes paid or credits due. However, a taxpayer should not rely on the IRS's inability to collect the payment because such limiting provisions are subject to change in future years through amendments to the ACA.

Employer Penalties under Health Care Reform

Another area of significant change is among employers with 50 or more full-time employees or full-time equivalents (large employers). The ACA imposes a non-deductible penalty on large employers, beginning in 2014, if any of their full-time employees qualify for and receive federal subsidies.

The excise tax is calculated at $2,000 annually multiplied by the total number of employees minus 30. For example, an employer with 100 employees subject to the excise tax would pay $2,000 x (100-30) = $140,000, if minimum essential coverage is not made available. For those employers who do offer minimum essential coverage, they will pay the lesser of the above-referenced amount or $3,000 multiplied by the number of employees who qualify for and receive federal subsidies.

Employers with less than 50 FTEs are encouraged to provide coverage for their employees with small business tax credits to help offset the employer contribution toward employee premiums.

Further, those employers that offer flexible spending accounts under a cafeteria plan will also need to pay close attention to the required limitations made effective in 2013 under the ACA. The maximum amount of pre-tax contributions allowed by each employee on an annual basis is set at $2,500. Because of this lowered amount, lawmakers are exploring the advisability of limiting the harsh effects to those who have money remaining in such accounts at year-end, which is currently a complete forfeiture; but as of now no leniency measures are available.

Conclusion

This Alert is intended to cover only certain tax changes made by the 2010 health care laws. It is important that taxpayers remain informed and well advised in order to strategically and efficiently traverse the ever-changing landscape of taxpayer compliance. Should you have any questions regarding any of the topics above or any other tax-related matters within such health care laws, please contact any one of the attorneys in the Firm's Tax Department.