

The Patient Protection and Affordable Care Act

Health care act includes variety of tax changes

President Obama signed the Patient Protection and Affordable Care Act, otherwise known as the Health Care Act, March 23 and subsequently signed a second bill that made a variety of changes to the original. Despite the President's signature on these two bills, it is not likely to be the end of the debate over health care reform that has dominated the country for the last year.

The day after the House passed the bill that was signed by President Obama, Republican lawmakers introduced legislation to repeal it. They've also said repealing and replacing this bill will be one of their main campaign points in the upcoming mid-term elections. Several states have filed lawsuits against the federal government claiming the act is unconstitutional by infringing on the rights of states. While there is much debate on the likelihood of any of these efforts being successful, there is no doubt we have not heard the last on health care.

So where does that leave taxpayers? As it stands now, there are several new taxes and penalties that are officially part of the tax code. The one advantage that taxpayers have is that most of the tax implications don't take effect until at least 2013, and some well past then. This gives taxpayers the ability to plan for these taxes, but also time for the rules to change once again.

Below is a summary of the primary tax provisions and selected other provisions in both the original bill and the reconciliation bill.

Additional Tax on Investment Income

The House reconciliation bill included an additional tax on net investment income referred to as the "Unearned Income Medicare Contribution". The tax would equal 3.8% of the lesser of (1) net investment income or (2) Modified AGI in excess of \$250,000 for a family (\$200,000 for a single taxpayer). Modified AGI for this tax is defined as Adjusted Gross Income increased by any net income excluded under the foreign earned income exclusion. Because this exclusion impacts relatively few taxpayers, most individuals should just think of this in terms of AGI.

Net investment income for purposes of this tax includes taxable interest (but not tax-exempt interest), dividends, capital gains, and annuity, rental and royalty income. Investment income earned in the course of a trade or business not defined as a passive activity would be exempt from this tax, as would distributions from qualified plans and IRAs. However, as is demonstrated below, these income items could indirectly trigger the Medicare tax. This tax would be effective beginning in 2013.

Additional Medicare Tax on High-Income Taxpayers

Also included in this plan is an increase in the Medicare tax. Today, the tax equals 1.45% of all wages paid

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to an employee. Beginning in 2013, this rate is increased by 0.9% to 2.35% for all wages earned by a family over \$250,000 (\$200,000 for single taxpayers). This tax is only imposed on individuals – there is no change to the Medicare tax paid by employers on those same wages.

Because this tax is imposed on family income, it is possible that neither spouse would be subject to this based on their own income level, but their combined income would put them over the threshold. For example, if two spouses each earn \$150,000, neither would be subject to the higher Medicare tax on their own. However, because their combined income of \$300,000 exceeds the \$250,000 threshold, the extra \$50,000 would be subject to the additional 0.9% tax.

If a taxpayer's own wages exceed the threshold, the employer is required to withhold the additional tax. However, employers aren't required to consider a spouse's income when determining the applicability of this section for their employee. This could mean that a family would be subject to the additional Medicare tax without having it withheld from their wages.

Combined Effect of New Taxes

While these two tax increases are both significant, they become even more so when combined with the likelihood of higher marginal tax rates on taxpayers over these same income thresholds. After 2010, the tax cuts enacted under President Bush are scheduled to expire, which would result in increased taxes for all individuals. President Obama has proposed keeping tax rates the same for lower income taxpayers, but raising them on families with more than \$250,000 of gross income (\$200,000 for singles). That proposal would also raise the top tax rate on long-term capital gains and qualified dividends from 15% to 20% on those same taxpayers. Below is a summary of the potential marginal tax rates (the tax applied to the next dollar of income) for different types of income and at different income levels:

Family Income Level	Type of Income	Marginal Tax Rate		
		2010	2011*	2013*
Total income between \$250,000 and \$373,000**	Dividends and long term gains	15%	20%	23.8%
	Interest, annuities and rental income	33%	36%	39.8%
Total income over \$373,000**	Dividends and long term gains	15%	20%	23.8%
	Interest, annuities and rental income	35%	39.6%	43.4%
Wages between \$250,000 and \$373,000***		33%	36%	36.9%
Wages over \$373,000 ***		35%	39.6%	40.5%

* Assumes passage of President's proposed budget

** The \$373,000 is based on 2010 tax brackets and would be adjusted for inflation between now and 2013

*** Assumes no other income. Other income could cause the ordinary tax rates to be reached at a lower level of wages

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This chart shows that for a taxpayer with income over \$250,000, the top marginal tax rate on their dividend income would rise from 15% in 2010 to 23.8% in 2013, a 59% increase. For wage income, someone in the top tax rate would see their rate go from 35% to 40.5%, a 16% increase.

The New Medicare Tax and Retirement Plan Distributions

This new Medicare tax is not applied directly to distributions from retirement plans or other retirement income sources (such as pensions and Social Security). However, because the tax applies once a family's MAGI exceeds \$250,000, those items can indirectly trigger the tax. Assume for example that in 2013 a family's income is exactly \$250,000, of which \$75,000 is dividend income. At that point, the new Medicare tax on investment income would not apply. However, every additional dollar of income they realize, including income due to withdrawals from an IRA, would trigger the 3.8% on the dividends, up to their amount of investment income (\$75,000 in this example).

Roth Conversions Become More Attractive

Any income that is not included in MAGI would not trigger this new tax. The best example of this would be qualified withdrawals from a Roth IRA, which are tax-exempt and are not included in MAGI. As a result, Roth IRA conversions, which as of 2010 are available to all taxpayers regardless of income, may be more appropriate. When evaluating whether to convert a Traditional IRA to a Roth, one of the factors to consider is the future tax rate on withdrawals from the Traditional IRA. If withdrawals from the Traditional IRA would trigger this new Medicare tax, those withdrawals become more expensive, which make withdrawals from a Roth IRA more attractive. While there are many other variables to consider before doing a Roth conversion, this new tax may be the deciding factor for some high-income individuals.

Change to Deduction for Medical Expenses

Qualified medical expenses are currently deductible to the extent they exceed 7.5% of the taxpayer's Adjusted Gross Income. Under this act, that floor will be raised to 10% beginning in 2013. For 2013 through 2016, the original 7.5% floor will continue to apply if the taxpayer or their spouse is age 65 or older by the end of the year.

Changes to Health Savings Arrangements

This act makes the following changes to how Health Savings Accounts (HSAs), Archer Medical Savings Accounts (MSAs) and flexible spending arrangements are funded and used:

- For 2010, there is a 10% penalty applied to HSA distributions that are not used for qualified medical expenses. For Archer MSAs, the penalty is 15%. This act increases both penalties to 20% beginning in 2011.



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- For employers that allow employees to defer income into a health flexible spending account, the deferrals will be limited to \$2,500 in 2013. Plans that allow for larger deferrals will not be considered qualified plans. This change does not apply to health reimbursement accounts.
- The definition of medical expenses has been conformed so that HSAs, MSAs and employer plans all follow the same rules. As a result, only prescribed drugs and insulin will be a qualifying medical expense for these accounts. Expenses for over-the-counter drugs will no longer be eligible for reimbursement or coverage.

Penalties for Not Purchasing Insurance Coverage

This act does not directly mandate that all individuals must purchase insurance coverage. However, beginning in 2014 penalties will be assessed that strongly incent individuals to do just that.

Under this act, individuals are required to maintain “minimum essential coverage”. Policies that offer “minimal essential coverage” generally include government-sponsored programs (such as Medicare and Medicaid), group health plans offered by employers or those purchased by individuals from within their state’s market. It does not include worker’s compensation or long-term care policies. Individuals will be subject to a penalty for every month during which they do not maintain coverage for themselves, a spouse or a dependent. The penalty will be based on a percentage of their income, with a minimum and maximum penalty amount, and will be phased in over time as shown below:

Year	Percentage of Income	Minimum Annual Penalty	Maximum Annual Family Penalty
2014	1.00%	\$95	\$285
2015	2.00%	\$325	\$975
2016	2.50%	\$695	\$2,085

Exceptions to the penalty apply in cases of hardship or to allow for transition from one plan to another. Also exempted are those claiming religious conscience exemptions, illegal aliens, members of an Indian tribe and incarcerated individuals, among others.

Tax Credits to Assist in Paying for Insurance

In order to offset the cost of insurance, the act allows for tax credits to be paid to individuals and families with income up to 400% of the poverty line (as determined by family size) beginning in 2014. The credit is equal to the amount that insurance premiums exceed a particular threshold, which is equal to a percentage of the family income. The threshold ranges from 2% of income for those with income up to 133% of the poverty line to 9.5% of income for those at 400% of the poverty line. No credit is available for those with income over 400% of the poverty line.

Penalties on Employers for Not Offering Coverage

As with individuals, employers are not mandated under this act to provide coverage to their employees. However, beginning in 2014, employers with at least 50 full-time employees will be subject to a penalty if (1) they do not offer health coverage to their employees or offer coverage that is deemed unaffordable and

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(2) any employee of that employer certifies they purchased health insurance from a state insurance exchange program with the help of the tax credit described above.

The penalty is equal to \$2,000 annually (\$166.67 per month) for each full-time employee (over a 30-employee threshold), regardless of how many employees are actually receiving the tax credit. For example, assume an employer has 100 full-time employees and does not offer them health coverage. If only one of those employees uses the tax credit to purchase coverage on their own, the employer would owe a penalty of \$166.67 per month for 70 employees, or \$140,000 annually.

The act also requires group health plans to cover 100% of the cost of preventive services and immunizations, prevents lifetime limits on benefits or unreasonable annual limits and requires plans to cover dependent children of covered individuals up to age 26. These specific changes are effective in 2011.

Excise Tax on High Cost Employer-Sponsored Health Coverage

Employer-provided insurance policies whose value exceeds a maximum threshold will be subject to a 40% excise tax on the excess value beginning in 2018. The threshold is equal to \$10,200 for benefits covering a single individual and \$27,500 for couples or families. This value would be indexed for inflation after 2018.

The tax is to be imposed on the provider of the coverage, not the covered individual. For those who receive coverage from their employer via a policy from an insurance company, the insurance issuer will be liable for the tax. Employers that are self-insured and act as the plan administrator themselves will be liable for the excise tax.

For eligible individuals, the thresholds above are increased to \$11,850 and \$30,950, respectively. This includes (1) retirees age 55 or older who aren't benefiting from Medicare and (2) participants of employer plans covering individuals in high-risk professions, such as law enforcement, fire fighters, EMTs and paramedics, among others.

In order to provide the IRS data to enforce this provision, employers will be required to note the aggregate cost of employer-sponsored health insurance as a footnote on employee's form W-2. This requirement is effective beginning in 2011.

Other Provisions

- **Modification to Adoption Credit** – Both the tax credit available to taxpayers adopting a child and the amount of adoption assistance that can be excluded from income will be increased to \$13,170 (a \$1,000 increase) effective for 2010. The credit will be indexed for inflation beginning in 2011.
- **Tax on Indoor Tanning Services** – The act creates a tax equal to 10% of the amount paid for indoor tanning services. This tax is to be paid by the person receiving the services and is to be collected by the provider.