

WNTS Insight

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*Supreme Court decision could affect
tax provisions enacted as part of
2010 health care law*

In brief

Congress in 2010 approved several significant revenue-raising tax provisions as part of the "Patient Protection and Affordable Care Act" and the related Reconciliation Act of 2010 (in combination, the "ACA" or "the Act"). Some of these tax provisions have become effective, including provisions codifying the economic substance doctrine and imposing an annual assessment on pharmaceutical manufacturers. Others are set to take effect next year -- including a new Medicare Hospital Insurance ("HI") tax on higher-income taxpayers and a tax on medical device manufacturers -- or in 2014 and beyond.

The ACA tax provisions could be affected by a U.S. Supreme Court decision on the constitutionality of the Act that is expected to be delivered before the end of this month. The Court in March heard three days of arguments on the following questions:

- Whether the Court may rule now on the constitutionality of the ACA's requirement that individuals must buy health insurance (the "individual mandate"), or whether a decision must be deferred until the tax penalty for not complying with the individual mandate becomes effective under the Act;
- Whether the individual mandate itself is constitutional;
- Whether other provisions of the Act should stand even if the mandate is found to be unconstitutional; and
- Whether the ACA's Medicaid expansion is constitutional.



While predicting how the Supreme Court will rule is extremely difficult, taxpayers may want to consider specific tax provisions that could be affected if the Court invalidates the ACA entirely. A decision fully invalidating the ACA also could affect companies' financial reporting in the case of certain tax provisions.

Note: It is not clear if the government would be required to refund any previously paid fees or taxes potentially affected by the Court's decision. If the Court does invalidate part or all of the ACA, it is expected that additional guidance will be provided in the decision as it relates to provisions previously in effect.

The following are some of the significant tax provisions that could be affected by the Supreme Court's decision.

Provisions currently in effect

Annual fee on pharmaceutical manufacturers

The ACA imposes an annual fee on the pharmaceutical manufacturing sector for each calendar year beginning after 2010. The fee ranges from \$2.5 billion to \$4.1 billion per year and is allocated across the industry based on relative market share. Pharmaceutical companies have paid their 2011 annual fee and the IRS currently is calculating the share of the 2012 annual fee to be paid by each covered entity on September 30.

The Joint Committee on Taxation (JCT) staff estimated in 2010 that the annual fee on pharmaceutical manufacturers will raise \$27 billion over 10 years.

Codification of the economic substance doctrine

As developed by the courts, the economic substance doctrine permits to be disregarded for tax purposes a transaction that complies with the literal terms of the Internal Revenue Code but, except for the expected Federal income tax benefits, lacks economic substance. Under the legislation, a transaction is treated as having economic substance only if (1) the transaction changes in a meaningful way (apart from the Federal income tax effects) the taxpayer's economic position, and (2) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into the transaction. Codification of the criteria to establish economic substance does not alter a court's determination as to whether the economic substance doctrine is relevant to a transaction.

The ACA provides a new 20-percent penalty for underpayments attributable to any disallowance of claimed tax benefits by reason of the transaction lacking economic substance. If the relevant facts affecting the tax treatment of the transaction are not adequately disclosed, the penalty increases to 40 percent. This penalty is a strict liability penalty -- the taxpayer may not avoid this penalty by demonstrating reasonable cause. As a result, a taxpayer cannot rely on an opinion as protection from the imposition of this penalty if the underlying transaction is found by a court to lack economic substance.

This codified economic substance standard became effective for transactions entered into after March 30, 2010.

JCT staff estimated in 2010 that this provision will raise \$4.5 billion over 10 years.

Note: Codification of the economic substance doctrine was debated as part of multiple bills over several years prior to the enactment of the ACA and subsequently has been the subject of extensive commentary and analysis by government officials

and the private sector. It is likely that debate over this issue would continue and consideration of legislation would resume if the codification provision is affected by the Court's ACA decision.

Exclusion of "black liquor" from biofuel producer tax credit

The cellulosic biofuel producer credit is a nonrefundable income tax credit for each gallon of qualified cellulosic fuel production of a producer during a tax year. The amount of the credit generally is \$1.01 per gallon. The legislation modified the cellulosic biofuel producer credit to exclude certain "black liquor" fuels produced as a byproduct of the paper manufacturing process, effective for fuels sold or used after December 31, 2009.

JCT staff estimated in 2010 that this provision will raise \$23.6 billion over 10 years.

Health savings account penalties

Distributions from a health savings account (HSA) or Archer medical savings account (MSA) must be used for qualified medical expenses; if not, they are subject to income taxation and an additional tax penalty. Starting in 2011, the legislation increases the penalty for nonqualified HSA or Archer MSA purchases or distributions from 10 to 20 percent and 15 to 20 percent, respectively.

JCT staff estimated in 2010 that this provision will raise \$1.4 billion over 10 years.

Tanning salons

The ACA imposes a 10-percent tax on amounts paid for indoor tanning services. The tax became effective on July 1, 2010.

JCT staff estimated in 2010 that this provision will raise \$2.7 billion over 10 years.

W-2 reporting

The ACA requires an employer to report on each employee's annual Form W-2 the value of the employee's health insurance coverage provided by the employer. The employer must include the value of all employer-sponsored plans in which the employee enrolls, including medical insurance as well as dental and vision coverage. To determine the value of employer-sponsored health coverage, the employer calculates the value of the plan using the rules for COBRA coverage. The provision became effective for tax years beginning after December 31, 2010.

Note: For certain employers, types of coverage, and situations, there is transition relief from the requirement to report the value of coverage on the 2012 Forms W-2 (the forms for calendar year 2012 that employers generally are required to provide employees in January 2013).

JCT staff estimated in 2010 that this provision will have a negligible revenue effect over 10 years.

Note: The ACA also included an expanded Form 1099 information reporting provision requiring a business to file an information return for all payments that total \$600 or more in the aggregate during a calendar year to a single business (other than to a tax-exempt corporation). This provision originally was scheduled to be effective after 2011, but its implementation was delayed and Congress ultimately repealed the provision last year before it went into effect.

Other provisions currently in effect

- A modification of section 833 treatment of certain health organizations;
- An excise tax on tax-exempt hospitals failing to satisfy an annual community health-needs assessment, and other requirements for tax-exempt hospitals; and
- An income exclusion for certain state loan repayment or forgiveness programs whose purpose is to increase the availability of health care services in areas that are underserved or have a shortage of health professionals.

Note: The ACA also provided a two-year therapeutic discovery project tax credit to encourage new therapies for acute and chronic diseases. This credit was available to certain companies in 2009 and 2010.

Provisions set to be effective in 2013 and beyond

Increased Medicare HI tax and new net investment income tax on higher-income taxpayers

The ACA beginning in 2013 increases by 0.9 percentage points the Medicare HI payroll tax paid by higher-income individuals, increasing the individual share of tax from 1.45 percent to 2.35 percent. The employer share would remain 1.45 percent.

The ACA also in 2013 adds a new 3.8-percent tax on net investment income, including capital gains, interest, dividends, annuities, royalties, and rents (other than such income that is derived in the ordinary course of trade or business that is not a passive activity).

Both the increased HI tax on wage income and the new tax on non-wage income will apply to individuals with incomes above \$200,000 for singles and \$250,000 for married couples filing jointly.

JCT staff estimated in 2010 that the increased Medicare HI taxes on wage and the new tax on non-wage income together will raise \$210.2 billion over 10 years.

Medical device excise tax

The ACA in 2013 imposes a 2.3-percent excise tax on the sale after 2012 of certain medical devices by a manufacturer, producer, or importer of such devices.

JCT staff estimated in 2010 that the provision will raise \$20 billion over ten years.

Note: The House on June 7, 2012, voted 270 to 146 to approve the "Protect Medical Innovation Act" (H.R. 436), a bill to repeal the medical device excise tax. H.R. 436 also would repeal another ACA provision that would restrict the use of flexible spending accounts (FSAs) and HSAs to purchase over-the-counter drugs. The White House has issued a veto threat against H.R. 436. Prospects for Senate consideration of this legislation are uncertain at this time.

Increase in AGI floor on medical expense deductions

The ACA increases the adjusted gross income threshold for claiming the itemized deduction for medical expenses from 7.5 percent to 10 percent beginning in 2013. The 7.5-percent threshold is retained through 2016 for individual taxpayers who have

attained age 65 (or have a spouse who has attained age of 65) before the close of an applicable tax year.

JCT staff estimated in 2010 that this provision will raise \$15.2 billion over 10 years.

Medicare Part D retiree subsidies

Employers are eligible for a subsidy under the Medicare Part D program if they sponsor drug coverage meeting certain standards for their Medicare-eligible retirees. The subsidy is calculated as 28 percent of the drug spending by eligible retirees within certain ranges. When Medicare Part D was enacted in 2003, the subsidy was made tax-deductible to encourage employers to continue to offer retiree drug coverage.

The ACA eliminates the deductibility of this subsidy, beginning in 2013. The elimination of deductibility had an immediate impact on the income statements of companies receiving the subsidy.

JCT staff estimated in 2010 that the elimination of the deduction for the retiree subsidy beginning in 2013 will increase revenues by \$4.5 billion over 10 years.

Deduction limit for insurance company compensation

The ACA imposes a \$500,000 deduction limit on executive compensation paid by health insurance providers. The provision is effective for compensation paid in tax years beginning after 2012 with respect to services performed after 2009.

JCT staff estimated in 2010 that the provision will raise \$600 million over 10 years.

Insurance industry assessment

The ACA provides for an annual assessment on health insurers totalling \$60.1 billion over 10 years. The provision is set to be effective in 2014.

Limits on FSAs

Under the ACA, the maximum contribution to a health FSA is limited to \$2,500 annually beginning with years after 2012. This amount is indexed for inflation based on the consumer price index (CPI-U) after 2013.

JCT staff in 2010 estimated that this provision will raise \$13 billion over 10 years.

Employer penalties

Beginning in 2014, the legislation imposes new non-deductible penalties on firms with 50 or more full-time employees that have employees enrolled in subsidized coverage in the new health insurance exchange created under the legislation. These subsidies are available only to individuals with incomes below 400 percent of the federal poverty level (in 2013, these caps would have been approximately \$44,000 for an individual and \$92,000 for a family of four). Employees meeting these income requirements will be eligible for the cost-sharing and premium subsidies under the legislation if they meet any of the following conditions:

- The employer does not offer coverage,
- The employer plan fails to cover 60 percent of health expenses, or
- The employee share of insurance premiums represents more than 9.5 percent of the employee's income.

CBO estimated that the employer mandates will raise \$52 billion in revenues between 2010 and 2019.

Tax on "High-Value" Health Plans

The ACA delays until 2018 implementation of the 40-percent excise tax on high-value insurance plans. In general, the excise tax is set to apply to the value of plans that exceed thresholds of \$27,500 for a family plan and to \$10,200 for a single plan. The ACA also provides for indexing the thresholds for inflation at CPI plus one percent, so that the threshold amounts would be adjusted upwards automatically if future health care costs increase at unexpected rates. The ACA also permanently adjusts the thresholds for employers facing higher healthcare costs due to the age or gender of their workers and for workers in high-risk professions.

JCT staff estimated that the tax on high-value health plans as enacted will raise \$32 billion over 10 years.

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