CCH Tax Briefing:

HEALTH CARE REFORM

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Special Report

HIGHLIGHTS:

- ✔ *Required Individual Coverage*
- ✔ *Enhanced Employer Responsibility*
- ✔ *Small Business Tax Credits*
- ✔ *Surtax on Higher-Income Individuals*
- ✔ *Limits on Exclusion for Employer-Provided Coverage*
- ✔ *Other Revenue Raisers*

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Health Care Reform Slows In Congress; Lawmakers Search For Consensus On Revenue Raisers

Health care reform legislation, once believed to be on the fast-track for approval in the House and Senate before Congress' August recess, has been moved to the fall as supporters continue to explore ways to pay for the estimated $1 trillion price tag. Four committees (House Ways and Means, House Education and Labor, House Energy and Commerce, and Senate Health, Education, Labor, and Pensions (HELP)) have reported out different versions of America's Affordable Health Choices Act, H.R. 3200. The Senate Finance Committee (SFC) failed to reach agreement on its health care reform bill before the August recess.

Impact *Two proposals have dominated the health care debate: a public plan to compete with private insurers and higher taxes (whether on insurers or higher-income individuals) to pay for reform. The House is expected to approve a public plan and surtax on higher-income individuals. Both proposals face serious opposition in the Senate. President Obama has said that a final bill must include a public plan and he has indicated his support for the House surtax proposal. At the same time, the White House has promised that a final bill "will not raise taxes on those making less than $250,000 a year." All this comes at a time when federal tax revenues are at their lowest level since 1932, according to the Treasury Department.*

Comment *Only the SFC is expected to draft and possibly pass a bipartisan health care reform bill. The bills approved by the House committees and the Senate HELP committee all passed along party-lines. Senior members of the SFC from both parties have indicated that they may have a bill ready by September 15 but have avoided setting a deadline. SFC Chair Max Baucus, D-Mont., has repeatedly said that the committee will report out a bill "when it is ready." Baucus told President Obama on August 6 that negotiations would continue throughout August, including videoconferences by SFC members.*

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, either through an employer or a national exchange. The national exchange (also called a "gateway") would allow individuals to shop among private insurers and a possible public insurance plan. Individuals who do not obtain acceptable coverage would be subject to a penalty. However, lower-income individuals would receive a credit or voucher to help pay for the cost of coverage.

Second: Employers currently offering health care coverage to their employees could elect to continue offering coverage so long as their plans meet certain minimum requirements. Employers electing not to offer 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.

Impact *The Tax Code plays a critical role in promoting both 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 the government needs to implement reform measures. In addition, the government is looking to health insurers, pharmaceutical companies and medical equipment providers to share in the costs of reform. All of these "revenue-related" components will form a major part of the debate before a final bill comes to a vote.*

INDIVIDUAL COVERAGE

Individuals would be required to obtain health insurance under the bills approved by the four committees. Individuals without employer-provided health insurance would have the option of securing coverage through the national exchange or gateway. If individuals do not obtain eligible coverage, they would be liable for an additional tax.

Under the Ways and Means bill, the additional tax would equal 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).

Impact *The additional tax would not exceed a yet-to-be-determined average premium for individual coverage (or family coverage) under a basic plan that is offered by the national exchange or gateway. The tax would be prorated for partial year failures.*

Impact *The 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.*

"Two proposals have dominated the health care debate: a public plan to compete with private insurers and higher taxes (whether on insurers or higher-income individuals) to pay for reform."

To reduce the economic burden of mandatory health care coverage, lower-income individuals would receive "affordability credits," vouchers to help pay for the cost of coverage purchased through the national exchange or gateway. The credits would be available on a sliding scale. Individual and family incomes must be below 400 percent of the federal poverty limit ($88,080 for a family of four) to qualify. Individuals eligible for employer-provided health insurance or Medicaid would not qualify for affordability credits.

Comment *The House bills and the Senate HELP bill would authorize the IRS to share taxpayer information with the national exchange to assist the exchange in determining eligibility for affordability credits.*

EMPLOYERS

Employers would be required to affirmatively elect to offer or not to offer health care insurance to employees. Employers electing to offer insurance must have their plans meet certain minimum coverage requirements. For example, an employer that offers a health benefit plan to its employees must offer both individual and family coverage. In addition, the employer's minimum contribution to plan premiums must be 72.5 percent of the lowest cost plan offered to individuals under the national exchange or gateway, and 65 percent of the lowest cost plan offered to families. For part-time employees, the minimum contribution amounts could be prorated. Salary reduction agreements with an employee would not constitute an employer contribution for this purpose.

Employers electing not to provide health care coverage would be subject to an additional payroll tax. The House Ways and Means Committee set that payroll tax at eight percent of the wages the employer pays to employees who are not offered health care benefits. The same definitions used for FICA purposes would be used for the additional payroll tax except that there would be no annual taxable wage base. For this purpose, an employer could make separate elections to provide health care coverage for separate lines of businesses, or full-time employees and part-time employees (or vice versa).

Comment *Employers electing to provide health care coverage that fails to meet the minimum coverage requirements would be subject to a penalty. Under the House Ways and Means bill, the penalty would be an excise tax of $100 per day for each employee to whom the minimum coverage* *fails to apply. Under the HELP bill, the penalty would be an annual fee of $750 per full-time employee and $375 for each part-time employee with the first 25 employees exempted.*

Comment *The House Energy and Commerce bill would exempt small businesses with annual payrolls of $500,000 or less from providing mandatory health insurance or the additional payroll tax.*

SMALL BUSINESSES

Lawmakers intend to mitigate the impact of mandatory employer-provided health care by providing tax credits to small businesses to subsidize coverage. The House Ways and Means bill would provide a credit for up to 50 percent of qualified health coverage expenses for the tax year for qualified small employers. These are employers with no more than 10 employees and whose average annual employee compensation does not exceed $20,000. A reduced credit would be available for employers with no more than 25 employees and whose average annual employee compensation does not exceed $40,000.

The House Ways and Means bill would also mitigate the additional payroll tax for small employers not offering coverage. Employers with annual payrolls not exceeding $250,000 during the preceding calendar year would not be subject to the additional tax. Employers with annual payrolls between $250,000 and $400,000 during the preceding calendar year would be subject to reduced rates.

Comment *The Ways and Means bill would not provide a credit for expenses incurred to cover any employee earning more than $80,000 per year. Also under special rules applicable to unincorporated businesses, a sole proprietor would be treated as an employee, as would each partner in a partnership.*

The Senate HELP Committee bill would target 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.

SURTAX

The Ways and Means surtax (which the Ways and Means Committee refers to as a "surcharge") would be imposed at progressive rates. For married couples filing jointly, a surtax of one percent would apply to the couple's modified AGI that exceeds $350,000 but does not exceed $500,000; a 1.5 percent rate would apply to the couple's modified AGI that exceeds $500,000 but does not exceed $1 million; and a 5.4 percent rate would apply to the couple's modified AGI that exceeds $1 million.

For single individuals and heads of household, the dollar amounts would be 80 percent of the above amounts. For married couples filing separately, the dollar amounts would be 50 percent of the above amounts.

Impact *The surtax would kick-in at the same time as anticipated increases in the top individual marginal income tax rates. President Obama has proposed raising the top two individual marginal tax rates to 36 percent and 39.6 percent respectively. This increase would affect individuals with taxable incomes of more than $200,000 ($250,000 for married couples filing jointly). This change would generate roughly $320 billion over 10 years in additional revenue. Congress is expected to pass this increase; however, Congress is not expected to approve Obama's plan to limit itemized deductions (including mortgage interest and charitable deductions) to 28 percent for higher-income individuals. Limiting itemized deductions would raise an additional $180 billion over 10 years.*

Comment *The dollar amounts for the surtax would be indexed for inflation after 2011.*

The surtax would apply to tax years beginning after December 31, 2010. The surtax would not be taken into account in computing alternative minimum tax (AMT) liability. Modified AGI for purposes of the surtax means AGI reduced by the amount of the investment interest deduction.

Sliding surtax. According to the Ways and Means Committee, the surtax includes a "trigger" that would completely eliminate the surtax (for tax years after 2012) on households making between $350,000 and $1 million if, in December 2012, the Office of Management and Budget (OMB) determines there will be more than $175 billion in extra savings above those currently projected by the Congressional Budget Office (CBO). If the extra savings are less than $150 billion, the one and 1.5 percent surtax

PROPOSED SURTAX

	Adjusted Gross Income (AGI) Level	Surtax Rate
Joint Filers:	$350K to $500K	1.0%
	$500K to $1 Million	1.5%
	Over $1 Million	5.4%
Single Filers:	$280K to $400K	1.0%
	$400K to $800K	1.5%
	Over $800K	5.4%

rates would be increased to two and three percent respectively. If extra savings exceed $150 billion but are less than $175 billion, the one percent and 1.5 percent rates would remain unchanged.

Comment *The SFC is unlikely to embrace the surtax proposal and supporters in the House are meeting resistance from colleagues. House Speaker Nancy Pelosi, D-Calif., has said she is open to revising the surtax when the bill comes before the full House for a vote.*

Comment *Congress has used a targeted surtax in the past. Congress enacted a 10-percent surtax on individual and corporate income in the Revenue and Expense Control Act of 1968 and lowered the surtax to five-percent in the Tax Reform Act of 1969. The surtax expired in 1970. The "temporary" 0.2 percent FUTA surtax, first enacted in 1976, was most recently extended in the Emergency Economic Stabilization Act of 2008.*

Comment *House Speaker Nancy Pelosi, D-Calif., has promised to bring a health care reform bill before the House in September. However, the pace could slow if opponents, including some of her own party members, seek to amend the bill on the House floor. The House Rules Committee will set the parameters for floor debate and amendment of the bill.*

EXCLUSION

The SFC is debating whether to limit the exclusion for employer-provided health care. Under current law, employer-provided health insurance is not counted as income for tax purposes and unlimited health care benefits are tax-free. The SFC has debated several proposals to limit the value of employer-provided health care that is excluded from gross income. One option would limit the exclusion for taxpayers whose incomes exceed a threshold level (for example, single individuals with AGI in excess of $200,000 and married couples filing jointly with AGI in excess of $400,000). Another option would be to include a dollar limit based on a benchmark plan; for example, the Federal Employees Plan.

Impact *According to the Joint Committee on Taxation, the pre-tax exclusion of health premiums is the largest health-related income tax benefit, costing approximately $133 billion in revenue in 2008. Benefits are also exempt from federal payroll taxes, a cost of nearly $94 billion in 2008.*

Comment *Employer-provided health insurance is estimated to cover between 60 and 70 percent of adults under the age of 65.*

Comment *President Obama has signaled his opposition to any major changes in the exclusion. Nonetheless, the SFC has not taken modifying the exclusion off the table. One way to make the exclusion more acceptable to the White House may be to grandfather existing coverage.*

EXCISE TAX ON INSURERS

The SFC is also debating whether to impose an excise tax on insurers offering high-end or "Cadillac" plans. An excise tax would equal a percentage of the amount by which premiums exceed certain thresholds. According to reports, the SFC is looking at plans valued at more than $10,000 for individual coverage and more than $25,000 for family coverage. The excise tax could apply starting in 2013.

Impact *According to the Center on Budget and Policy Priorities (CBPP), a threshold at $25,000 for family coverage would affect fewer than five percent of taxpayers. Ninety-five percent of families would have premiums of less than $21,000 in 2013, CBPP predicted.*

Comment *It is unclear if the excise tax would be indexed for inflation. Between 1990 and 2007, the rate of inflation for national health care expenditures grew by 5.9 percent. Congress could also vary the excise tax by region to mitigate the impact on high-cost localities.*

Comment *Some of the benefits of these high-dollar policies include gym memberships, yoga classes and home exercise equipment.*

FLEXIBLE SPENDING ARRANGEMENTS

A health flexible spending arrangement (FSA) allows employees to pay for eligible out-of-pocket health care and dependent care expenses with pre-tax dollars. Taxpayers may use savings in a health FSA to purchase over-the-counter medications. Reimbursements by FSAs for most nonprescription drugs are not subject to tax if properly substantiated by the employee. The Ways and Means bill would prohibit taxpayers from using health FSA dollars to pay for over-the-counter medications. The proposal is estimated to raise $8.2 billion over 10 years.

Comment *The Ways and Means proposal would also extend to health savings accounts (HSAs), health reimbursement arrangements (HRAs) and Archer Medical Savings Accounts (Archer MSAs).*

DOMESTIC PARTNERS

The Ways and Means bill would extend the exclusion from gross income for employer-provided health coverage for employees' spouses and dependent children to coverage provided to domestic partners. The proposal would cost $4 billion over 10 years.

Impact *Domestic partners are not treated as spouses for federal tax purposes. Consequently, an employee pays tax on the fair market value of the cost of coverage for the employee's domestic partner. The Ways and Means proposal would level the playing field for spouses and domestic partners.*

Comment *The House Education and Labor and Senate HELP Committee bills do not include this treatment for domestic partners.*

ALCOHOL AND OTHER BEVERAGE TAXES

Under current law, the taxes on alcoholic beverages vary on the type of beverage. One proposal in Congress would tax all alcoholic beverages at a uniform rate. Another proposal would impose a new tax on sweetened beverages, possibly a tax of one cent on a can of sweetened beverage.

Comment *The current federal tax on distilled spirits is $13.50 per proof gallon with some exceptions.*

WORLDWIDE ALLOCATION OF 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. The Ways and Means bill would delay the effective date of worldwide allocation of interest rules until tax years beginning after December 31, 2019. The proposal is projected to raise $26.1 billion over 10 years.

ECONOMIC SUBSTANCE DOCTRINE

The Ways and Means bill would codify 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. While the provision provides a uniform definition of economic substance, it does not change the current standards for determining when the economic substance analysis applies. The proposal is projected to raise $3.6 billion over 10 years.

Comment *Taxpayers with understatements attributable to a transaction lacking economic substance would be liable for a 20 percent penalty. The penalty would be 40 percent where relevant facts affecting the tax treatment of the transaction are not adequately disclosed.*

TREATY BENEFITS

New limits would be put in place to prevent foreign multinational corporations from avoiding tax on income earned in the U.S. The proposal targets the practice of having a U.S. subsidiary of the foreign corporation making a deductible payment to a tax treaty jurisdiction before repatriating those earnings. The proposal is projected to raise $7.5 billion over 10 years.

OTHER REVENUE RAISERS

In addition to the surtax, a delay in the worldwide allocation of interest, codification of the economic substance doctrine, and the closing of certain treaty benefits, a handful of other non-health care related provisions are also being considered as possible candidates for the revenues needed to fund health-care reform. They include:

International tax reforms. President Obama has proposed a package of international tax reforms estimated to generate approximately $210 billion over 10 years. Among other things, the proposals would defer foreign-source deductions (except for the research and experimentation tax credit), reform the business entity classification rules, and require taxpayers to determine foreign tax credits and earnings and profits on a consolidated basis for all controlled foreign corporations.

LIFO repeal. Lawmakers also may repeal the last-in, first-out (LIFO) method of accounting. According to the White House, LIFO repeal would raise approximately $61 billion over 10 years.

Carried interest. The Obama administration has endorsed a change in the tax treatment of so-called carried interest. A partner's share of carried interest not attributable to invested capital would be taxed as ordinary income. The White House predicts the change in tax treatment would raise approximately $24 billion over 10 years.

Cap and trade. In June, the House passed climate change legislation. The American Clean Energy and Security Act would reduce carbon emissions, boost the production of renewable energy, and invest in new energy technologies. The Obama administration has proposed using projected revenues from auctioning emissions allowances to make permanent the Making Work Pay Credit and help lower-income individuals pay for higher energy prices.

Tax shelters. The Senate may consider the Stop Tax Haven Abuse Act, which would increase reporting and disclosure of offshore accounts, identify so-called tax haven jurisdictions and establish new presumptions for certain offshore transactions. Another Senate bill would impose a 100 percent excise tax on SILO and LILO transactions.

Impact ***In the current economic climate any of the revenue raisers currently being considered to pay for health-care reform are likely candidates for*** *passage within the next year, whether as part of a final health-care bill or separately. Most of the revenue raising provisions now up for grabs have been floated seriously on Capital Hill for at least the past year and which ones get passed may just be a question of which bill gets there first.*