



Part III: Federal Tax Law May 2010, Volume 1

Health Care Reform and Federal Tax Law Changes

On March 23, 2010 (the “Enactment Date”), President Obama signed into law the Patient Protection and Affordable Care Act, which was later amended on March 25, 2010, by the Health Care and Education Reconciliation Act of 2010 (as so amended, the “PPACA”). In prior alerts, Shipman & Goodwin LLP outlined (i) PPACA initiatives relating to health care law compliance, and (ii) changes to federal pension and employee benefit law that will be effective in 2010 and 2011. Future alerts will focus on additional health care law and employee benefit law changes, including mandatory coverage requirements and the associated tax incentives and penalties enacted in connection with those requirements. In this alert, we focus on some of the more significant non-employee-benefit federal tax law changes enacted as part of PPACA. We caution that many of the details of the tax law changes summarized below still need to be determined as part of regulations to be issued by the Department of the Treasury and/or as part of guidance to be published by the Internal Revenue Service. As part of our Health Care Reform Informational Series, we will disseminate additional updates when such regulations and guidance are published.

- **New Exemption Requirements for Charitable Hospitals.** Effective for taxable years beginning on or after the Enactment Date, a hospital exempt from federal income taxation as an organization described in Section 501(c)(3) of the Internal Revenue Code (a “charitable” or “tax-exempt” hospital) will be subject to the following four additional requirements in order to maintain its federal tax exemption (new Code §501(r)):
 - ◆ The hospital must conduct a community health needs assessment once every three taxable years **and** adopt an implementation strategy to meet the community needs identified through the assessment. The assessment process must take into account input from persons who represent the broad interests of the community served by the hospital, including those with special knowledge of or expertise in public health, and the assessment must be made widely available to the public. Failure to complete the assessment in any three-year period results in a \$50,000 penalty on the hospital. Failure to disclose on the Form 990 how the hospital is meeting the needs identified in the assessment can result in the Form 990 being deemed incomplete. The first community health needs assessment and implementation strategy must be completed by the hospital no later than its third taxable year after the Enactment Date.
 - ◆ The hospital must adopt, implement and widely publicize a written financial assistance policy. The policy must include: (i) eligibility criteria for financial assistance, and whether such assistance includes full or discounted care; (ii) the basis for calculating amounts charged to patients; (iii) the method for applying for financial assistance; (iv)

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if the hospital does not have a separate billing and collections policy, the actions that may be taken in the event of nonpayment, including collections action and reporting to credit agencies; and (v) measures to widely publicize the policy within the community. The hospital also must have a written policy to provide emergency medical treatment to individuals without discrimination against those individuals who are eligible for assistance under the hospital's financial assistance policy or for government assistance.

- ◆ If an individual qualifies for assistance under the hospital's financial assistance policy, the hospital may not use gross charges (i.e. "chargemaster" rates) for emergency or other medical necessary care, but must use one of the following: (i) the best negotiated commercial rate; (ii) the average of the three best negotiated commercial rates; or (iii) the Medicare rate.
- ◆ A hospital may not undertake extraordinary collection actions (including lawsuits, liens on residences, reports to credit rating agencies, etc.) against an individual without first making reasonable efforts to determine whether the individual is eligible for assistance under the hospital's financial assistance policy. "Reasonable efforts" include notification of the policy upon admission and in written and oral communications with the patient regarding the patient's bill, including invoices and telephone calls, and before a collection action or a report to a credit rating agency is initiated.
- **New Hospital Reporting and Disclosure Requirements.** Effective for all taxable years commencing after the Enactment Date, a charitable hospital shall be required to provide with its Form 990 a description as to how the hospital is addressing the needs identified in each community health needs assessment. The description also must identify expressly any needs identified in a community health needs assessment that are not being addressed, and set forth the reasons why such needs are not being addressed. In addition, the hospital is required to attach to the Form 990 the audited financial statements of the hospital or of a consolidated group of which it is a member.
- **Mandatory Treasury Review of Hospitals.** PPACA requires the Secretary of the Treasury to: (i) review at least once every three years the community benefit activities of each charitable hospital; (ii) submit an annual report to certain Congressional committees on (A) the level of charity care, bad debt expenses and unreimbursed costs for services provided with respect to each of means-tested and non-means tested government programs for each of tax-exempt, taxable and governmental hospitals, and (B) information with respect to the costs incurred by tax-exempt hospitals for community benefit activities; and (iii) submit a report, not later than five years after the Enactment Date based on a study of the trends in the above-described annual reports. Certain Congressional leaders have expressed their intent to use the report on trends in charity care and community benefit activities to evaluate whether it is appropriate to continue the federal income tax exemption for charitable hospitals.
- **Additional Hospital Insurance Tax on High-Income Taxpayers.** Effective for remuneration paid on or after January 1, 2013, the hospital insurance tax portion of the Federal Insurance Contribution Act ("FICA") tax is increased by 0.9% (from 1.45% to 2.35%) with respect to wages above \$250,000 for taxpayers filing a joint return, \$125,000 for a married individual filing a separate return, and \$200,000 for other taxpayers. The increased tax is paid entirely by the employee; the employer's portion of the tax remains at 1.45%. An identical increase is imposed with respect to self-employment income, thereby increasing the rate of the hospital insurance tax portion of the Self-Employment Contribution Act ("SECA") tax from 2.9% to 3.8% (but no portion of the additional 0.9% increase will be deductible). Please note that under current law there is no cap on the wages or self-employment income subject to the hospital insurance tax. In determining an employer's requirement to withhold and liability for the tax,

only wages that the employee receives from the employer in excess of \$200,000 for a year are taken into account, and that employer need not account for wages paid to an employee by another employer or to an employee's spouse. Employees will need to address independently any potential underwithholding when determining their estimated tax liability.

- **Unearned Income Medicare Contribution on High-Income Taxpayers.** Effective for taxable years beginning on or after January 1, 2013, a new unearned income Medicare contribution tax is imposed on individuals, estates and trusts. In the case of individual taxpayers, the tax is 3.8% of the lesser of (i) the taxpayer's "net investment income"; or (ii) the excess of the taxpayer's "modified adjusted gross income" over the "threshold amount." "Net investment income" generally is the taxpayer's net income from (i) interest, dividends, annuities, royalties and rents (except to the extent such items are from an active trade or business or are excludible from gross income under the income tax, such as interest from tax-exempt funds), (ii) a trade or business, if it is a passive activity as it relates to the taxpayer, (iii) a trade or business of trading in financial instruments or commodities, or (iv) gain attributable to the disposition of property other than property held in a trade or business. (Investment income does not include distributions from a qualified retirement plan.) Modified adjusted gross income is adjusted gross income increased by the individual's otherwise excludable foreign earned income. The applicable "threshold amount" is \$250,000 in the case of a joint return or a surviving spouse, \$125,000 in the case of a married taxpayer filing separately, and \$200,000 in the case of all other taxpayers. In the case of an estate or trust, the tax is 3.8% of the lesser of (i) undistributed net investment income or (ii) the excess of adjusted gross income over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins (currently \$7,500). The tax is subject to the individual estimated tax provisions. As a result of the new tax, if the Bush Administration tax cuts are allowed to expire at the end of 2010, taxpayers with income above the threshold amounts would see the tax on dividend income increase from the current rate of 15% to 43.4% for taxpayers in the highest marginal tax bracket.
- **Modification of Itemized Deduction for Medical Expenses.** Effective for taxable years commencing on or after January 1, 2013, the threshold for deducting medical expenses on a federal tax return of an individual who is under the age of 65 (and whose spouse is under the age of 65) will increase from 7.5% to 10% of the individual's adjusted gross income. The threshold for all taxpayers, including those 65 and older, will be 10% in 2017 and subsequent years.
- **Elimination of Deduction for Expenses Allocable to Medicare Part D Subsidy.** Effective for taxable years beginning on or after January 1, 2013, an employer will no longer be able to deduct the expense of offering retiree prescription drug coverage to the extent of the federal subsidy payments received by the employer under Medicare Part D for such coverage. Please note that this change may result in a financial statement adjustment, requiring a reduction in the deferred tax asset of an employer which provides this coverage.
- **Annual Fee on Health Insurance Providers.** Commencing in 2014, "any entity which provides health insurance for any United States health risk" will be required to pay a share of an annual industry-wide fee which will be nondeductible for federal income tax purposes. The aggregate fee is set at \$8 billion in 2014, increases eventually to \$14.3 billion in 2018, and will be indexed in subsequent years to the rate of premium growth. The aggregate annual fee is apportioned among providers based on a ratio of net written premiums and is designed to reflect their relative market share of the national health insurance business, subject to certain full and partial exclusions. The fee generally is not applicable to governmental entities, employers who self insure, voluntary employee benefits associations ("VEBAs") that are established for purposes of providing health care benefits by an entity (other than an employer

or employers), or certain nonprofit entities that generally do not engage in the political process and that derive more than 80% of gross revenues from government programs targeting low income, elderly or disabled populations. A 50% exclusion is afforded to the net written premiums that are attributable to the exempt activities of certain tax-exempt health insurance organizations.

- **Limitation on the Deduction for Compensation Paid by Certain Health Insurance Providers.** Effective generally for taxable years beginning on or after January 1, 2013, for services rendered on or after January 1, 2010, a health insurance provider generally will not be able to deduct the compensation paid to a director, officer, employee or independent contractor for services performed during an applicable tax year to the extent the compensation exceeds \$500,000. All remuneration from all members of any controlled group of corporations, other businesses under common control, or an affiliated service group is aggregated.
- **Annual Fee on Branded Prescription Pharmaceutical Manufacturers and Importers.** Commencing in 2011, any “manufacturer or importer with gross receipts from branded prescription drug sales” will be required to pay a share of an annual industry-wide fee which will be nondeductible for federal income tax purposes. The total fee is set at \$2.5 billion in 2011, increases eventually to \$4.1 billion in 2018, and then drops down to, and remains at, \$2.8 billion in 2019 and subsequent years. The Secretary of the Treasury will calculate the amount of each entity’s fee based on its relative market share of branded prescription drug sales, and will set a date for payment of the fee which will be no later than September 30th of each calendar year.
- **New Tax on Sales of Medical Devices.** Effective for sales on or after January 1, 2013, a tax is imposed on the sale of any “taxable medical device” by the manufacturer, producer or importer equal to 2.3% of the sales price. A “taxable medical device” means generally any device as defined in section 201(h) of the Federal Food, Drug, and Cosmetic Act that is intended for humans, other than eyeglasses, contact lenses, hearing aids and any other medical device determined by the IRS to be of a type which is generally purchased by the general public at retail for individual use. The general exemption from federal sales taxes on sales of supplies to vessels or aircraft, state and local governments, nonprofit educational organizations and certain blood collector agencies will not be applicable to this tax.
- **Modification of Tax Treatment of Certain Blue Cross & Blue Shield and Qualifying Organizations.** Commencing with taxable years beginning on or after January 1, 2010, the special tax treatment under Internal Revenue Code § 833 for certain Blue Cross and Blue Shield and other qualifying organizations will not be available to an organization whose medical loss ratio is under 85% for the taxable year (determined on an organization-by-organization basis and not on an affiliated group basis). The special tax treatment generally includes: (i) a deduction equal to 25% of (A) claims incurred, and liabilities incurred under cost-plus contracts, for the taxable year, and (B) expenses incurred in connection with the administration, adjustment, or settlement of claims or in connection with administration of cost plus contracts during the taxable year, to the extent this sum exceeds the adjusted surplus at the beginning of the taxable year; and (ii) an exception from the application of the 20% reduction in the deduction for increases in unearned premiums.
- **Excise Tax on High Cost or “Cadillac” Employer-Sponsored Health Coverage.** Commencing with taxable years beginning on or after January 1, 2018, a nondeductible excise tax is imposed on a “coverage provider” equal to 40% of the “excess benefit” provided in any month under an employer-sponsored health plan. A “coverage provider” is (i) the health insurance issuer, in the case of a group health plan; (ii) the employer in the case of

plans under which the employer makes contributions to a Health Savings Account or Archer MSA; or (iii) the administrator, in all other cases. The “excess benefit” is the cost of coverage which, on an annual basis, exceeds \$10,200 per year for an individual and \$27,500 per year for a family (\$11,850 for an individual and \$30,950 for a family in the case of a qualified retiree or an employee who participates in a plan sponsored by an employer the majority of whose covered employees are engaged in a high-risk profession or employed to repair or install electrical or telecommunications lines). The foregoing thresholds, which do not include certain coverages such as long term care and separate dental and vision care, are tentatively set for 2018; however, they will be increased for 2018 by the “health cost adjustment percentage” if the increase in the cost of health care coverage during the period from 2010 to 2018 exceeds the projected growth for that period. The “health cost adjustment percentage” is equal to 100% plus the excess, if any of: (i) the percentage by which the per-employee cost of coverage under the Blue Cross/Blue Shield standard benefit option under the Federal Employees Health Benefits Plan for plan year 2018 exceeds the per-employee cost for plan year 2010; over (ii) 55%. The threshold is further increased to the extent the cost of providing such coverage to the employee under the Federal Employees Health Benefits Plan (if priced for the age and gender characteristics of the individual’s employer) exceeds the premium cost of that same coverage priced for the age and gender characteristics of the national workforce. After 2018, the thresholds will be subject to an annual cost-of-living adjustment (plus 1% in 2019). Please note that excess benefit calculations will be the responsibility of the employer (or the plan sponsor of a multi-employer plan), who must notify the coverage provider and the Secretary of the Treasury, and the employer or plan sponsor (rather than the insurer or administrator) will be liable for penalties in the case of inaccurate calculations.

- **Exempt Member-Run Health Issuers.** As part of PPACA, the Secretary of Health and Human Services is to establish the Consumer Operated and Oriented Plan to foster the creation of new qualified nonprofit health insurance issuers to offer qualified health plans in the individual and small group markets. Six billion dollars in funding is authorized to provide loans and grants under the program. A qualified nonprofit health insurance issuer generally is a nonprofit, member corporation which is governed by its members, and substantially all of the activities of which consist of the issuance of qualified health plans in the individual and small group markets. If the issuer meets these and other requirements, the issuer will be exempt from federal income tax with respect to periods during which it is in compliance with such requirements and the terms of any program grant or loan agreement to which it is a party. The issuer will not qualify if it, a related entity or a predecessor of either was a health insurance issuer as of July 16, 2009, or if it is sponsored by a state or local government.
- **Investment Credit for Qualifying Therapeutic Discovery Projects.** A new 50% non-refundable investment tax credit is created for investments in “qualifying therapeutic discovery projects,” effective for expenditures paid or incurred on or after January 1, 2009. A “qualifying therapeutic discovery project” is a project designed to develop a product, process or therapy to diagnose, treat or prevent diseases and afflictions by (i) conducting pre-clinical trials, clinical trials, clinical studies and research protocols, or (ii) developing technology or products designed to diagnose diseases and conditions or to further the delivery or administration of therapeutics. To qualify, a company must have 250 or fewer employees and must apply to the Secretary of the Treasury to obtain certification for a qualifying investment. Certain taxpayers may elect to receive credits allocated to it in the form of a taxable Treasury grant equal to 50% of the qualifying investment. One billion dollars has been allocated for the program for the two-year period 2009 through 2010.
- **Increased Information Reporting Requirements.** Effective for payments made on or after January 1, 2012, any person engaged in a trade or business that makes a payment in the course of such trade or business of “amounts in consideration for property” will need to report

the gross proceeds of that transaction on a Form 1099-MISC. In addition, as of that same effective date, the exception for reporting payments to corporations on a Form 1099-MISC is repealed.

- **Codification of Economic Substance Doctrine.** In general, the economic substance doctrine has been a common law doctrine under which tax benefits with respect to a transaction will not be recognized if the transaction lacked economic substance or a business purpose. Effective for transactions entered into after the Enactment Date, whenever the economic substance doctrine is relevant to a transaction, the transaction will be treated as having economic substance only if (i) the transaction changes in a meaningful way (apart from federal, state and local income tax effects) the taxpayer's economic position, *and* (ii) the taxpayer has a substantial purpose (apart from federal, state and local income tax effects) for entering into such transaction. A transaction's potential for profit can be taken into account only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits of the transaction. The accuracy-related underpayment penalties are extended to any transaction deemed to lack economic substance, and the underpayment penalty is increased from 20% to 40% for such a transaction if not disclosed in connection with a tax return (or amended return filed prior to notification of an audit). In addition, in the event economic substance is found not to exist, the taxpayer will not be able to take advantage of the reasonable cause exception to the underpayment penalty, the reasonable cause exception to the penalty for a reportable transaction understatement, or the reasonable basis exception to the penalty for an erroneous claim for refund or credit. The new economic substance standard will not apply to an individual unless the transaction was entered into by the individual in connection with a trade or business or an activity engaged in for the production of income.
- **Estimated Tax Payment for Large Corporations.** In the case of a corporation with assets of not less than one billion dollars (determined as of the end of the preceding taxable year), the amount of any required installment of corporate estimated income tax which is otherwise due in July, August or September of 2014 is increased by 15.75 percentage points.
- **Adoption Credit and Employer-Provided Adoption Assistance.** PPACA improves and expands the adoption tax credit and the exclusion for qualified adoption expenses paid or reimbursed by an employer, but the improved and expanded benefits will be short-lived due to the sunset provisions contained in the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") which were delayed for only one year. Effective for 2010, the maximum tax credit for qualified adoption expenses is increased by \$1,000 from \$12,170 to \$13,170, for both non-special needs adoptions and special needs adoptions, and the credit is made refundable. The new dollar limit and the current adjusted gross income levels at which the credit is phased out are adjusted for inflation in taxable years beginning on or after January 1, 2011; however, as of January 1, 2012, the applicable EGTRRA sunset provision will lower the credit for special needs adoptions to \$6,000, eliminate the tax credit for non-special needs adoptions, and lower the phase-out adjusted gross income levels. Similarly, the exclusion from the gross income of an employee for qualified adoption expenses paid or reimbursed by an employer under an adoption assistance program is increased by \$1,000 for 2010 from \$12,170 to \$13,170. Again, the new dollar limit of the exclusion and the phase-out adjusted gross income levels are adjusted for inflation for taxable years after 2010, but the EGTRRA sunset provision, which will eliminate the exclusion, is delayed only one year until 2012.
- **Exclusion for Assistance Provided to Participants in Student Loan Repayment Programs for Certain Health Professionals.** Although gross income generally includes the discharge of indebtedness of a taxpayer, there is an exception for the forgiveness of certain student loans if that forgiveness is contingent on the student's working for a certain period of



time in certain professions. Effective for amounts received by an individual on or after January 1, 2009, the exclusion is extended to amounts received under the National Health Service Corps loan repayment program or certain state loan repayment programs attributable to any amount received by an individual under a state loan repayment or forgiveness program that is intended to provide for the increased availability of health care services in underserved or health professional shortage areas (as determined by the state).

- **Excise Tax on Indoor Tanning Services.** Effective for services performed on or after July 1, 2010, an excise tax is imposed on each individual receiving indoor tanning services equal to 10% of the amount paid for the service. If the tax is not paid by the recipient of the service, it must be paid by the person providing the service. The tax is not applicable to a phototherapy service performed by a licensed medical professional.
- **Cellulosic Biofuel Producer Credit.** For fuels sold on or after January 1, 2010, the fuel eligible for the cellulosic biofuel producer credit no longer includes any fuel if (i) more than 4% of such fuel (determined by weight) is any combination of water and sediment, or (ii) the ash content of such fuel is more than 1% (determined by weight).

Questions or Assistance?

We encourage you to consult with your tax advisor to determine how these tax law changes will impact you based upon your individual facts and circumstances. In addition, we urge you not to defer addressing a tax law change that has an effective date that is years from now; such provisions may have a more immediate impact on your balance sheet or operations or require careful advance planning to address. If you have questions regarding these changes, please contact one of the following members of our Tax Law Practice Group.

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