

Taxes—Paying for Healthcare Reform

Everyone has an opinion of the healthcare reform package currently working its way through Congress. Currently, the legislation has passed in the Senate, but it must be reconciled with the House version before going forward. One thing is certain: healthcare reform won't be cost-free. Both the House and Senate versions include not only expanded health coverage, but also "revenue enhancers" intended to offset the anticipated price tag of reform. Not surprisingly, most of these are targeted at high-net worth (HNW) and affluent clients.

House Bill

The Affordable Health Care for America Act (H.R. 3962), passed by the House in November of 2009, enhances revenue in large part by imposing a surtax on higher-income individuals. The surtax of 5.4 percent would apply to individuals whose adjusted gross income exceeds \$500,000 (\$1 million for married couples filing joint returns). Presumably, individuals subject to the tax would increase their tax bill by 5.4 percent. Thus, an individual with \$100,000 due in taxes would be required to pay \$105,400 with the surtax. The new surtax would apply to tax years beginning after December 31, 2010.

In addition, the House bill would impose a 2.5 percent excise tax on medical devices. The tax would be imposed on the "first sale" of such devices by manufacturers to health care providers. The term medical device is broadly defined in the Federal Food, Drug, and Cosmetic Act and includes a wide range of products such as tongue depressors, medical thermometers, blood sugar meters, defibrillators, and X-ray machines. This provision is expected to be hotly contested. Proponents see the surtax as a way to require the highly-profitable manufacturers of medical devices to pay their fair share of expanded health care coverage. Opponents view the surtax as an impediment to innovation by such manufacturers and fear that the tax will be passed on to consumers through increased costs.

Furthermore, the House Bill would "set forth rules for the application of the economic substance doctrine and impose penalties for underpayments of tax due to transactions lacking economic substance." Currently, "economic substance" is a judicial doctrine applied to a wide variety of transactions. Under current law, the approach used by the majority of circuit courts employs both a subjective and an objective test, which the taxpayer must pass in order to avoid a lack of economic substance challenge. Meeting both tests is challenging for the typical tax shelter in which the costs of entering into the transaction are substantially greater than the true economic gain that stands to be realized.

The House bill would use a similar two-pronged test and assure consistency of application of the doctrine across the judicial system. Violations are subject to stiff, automatic penalties of 20 or 40 percent, depending on the nature of the underlying transaction.

The Senate Bill

Unlike the House bill, with its broad-based surtax on high-income earners, the Senate bill is more strategic in the ways it goes about raising revenue.

Beginning in 2009, the Senate bill would cut in half (to \$500,000) the amount of an executive's compensation that a healthcare provider could deduct from its corporate income taxes.

Also, beginning in 2009, the Senate would impose annual fees on manufacturers and importers of branded drug, manufacturers and importers of certain medical devices, and manufacturers and importers of health insurance plans. Similarly to the House bill, which places a surtax on manufacturers of medical devices, these provisions are designed to assure that those currently profiting the most from healthcare pay their fair share of the reform. However, some believe these provisions will simply increase costs as manufacturers and importers pass costs on to consumers.

The House Bill seeks to codify the judicial doctrine requiring tax transactions to show economic substance. Many tax shelters promoted to HNW clients will find it difficult to pass the two-pronged test.

In one of the more controversial provisions of the bill, beginning in 2010, the Senate would impose a five percent excise tax on cosmetic surgery and similar procedures. The Senate bill would exclude cosmetic surgery necessary to ameliorate a deformity arising from or directly related to a congenital abnormality, a personal injury resulting from an accident or trauma or a disfiguring disease.

Beginning in 2012, the Senate bill also raises the threshold for the itemized medical expense deduction from 7.5 percent of adjusted gross income (AGI) to 10 percent of AGI for regular income tax purposes effective for tax years beginning after December 31, 2012. However, individuals age 65 and older (and their spouses) would be temporarily exempted from the increase.

Another provision would impose a 40 percent excise tax on the cost of health coverage in excess of \$8,500 for individuals (\$23,000 for families). These dollar amounts would be indexed for inflation. The tax on these "Cadillac Plans" would be levied at the *insurer* level, but the increased cost would, presumably, be passed on to consumers. The tax would be effective for tax

years beginning in 2013. Also the levels for expensive coverage for high-risk jobs such as law enforcement personnel, fire fighters and other first responders, as well as individuals in high-risk occupations, such as mining, have been increased to \$9,850 for individual coverage and \$26,000 for family coverage. Retired individuals age 55 and older would also be eligible for the higher thresholds.

Also beginning in 2013 there would be an additional 0.5 percent Medicare tax on wages in excess of \$200,000 (\$250,000 for joint filers). Currently the Medicare portion of FICA taxes at 1.45 percent. Presumably, the new tax would work as follows:

- For single filers, wages above \$200,000 would be subject to Medicare payroll taxes of **1.95 percent (combined employer and employee)**. Thus, for each \$1,000 earned above \$200,000, an additional five dollars in payroll taxes would be due.
- For joint filers, wages above \$250,000 would be subject to Medicare payroll taxes of **1.95 percent (combined employer and employee)**. Thus, for each \$1,000 earned above \$250,000, an additional five dollars in payroll taxes would be due.

The tax increase would also apply to self-employed individuals.

The Bottom Line

At the time of this writing, the Senate bill is stalled, with Joe Lieberman of Connecticut objecting to a provision that would allow individuals as young as age 55 to buy into Medicare. This objection is consistent with Lieberman's position against any type of public option. Without Lieberman's vote, the chance of any bill passing the Senate is unlikely. However, many believe that the President and liberal Democrats, who have supported a public option, will settle for any plan at this point.

Keep a wary ear to the ground.

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