

## Testimony—Interim Taxation Committee

August 1, 2012

Prepared by Joseph Becker, Auditor III  
Research and Education Section  
North Dakota Office of State Tax Commissioner

Phone: 328-3451  
E-mail: jjbecker@state.nd.us

Chairman Hogue and Members of the Committee:

### Introduction

My name is Joseph Becker, and I'm here on behalf of the North Dakota Office of State Tax Commissioner (Tax Department). The Tax Department was asked to appear before the Committee to brief it on the following items:

1. What is the new federal 3.8% Medicare contribution tax on unearned income<sup>1</sup> that will take effect in 2013, and does it apply to the sale of a home?
2. What other tax provisions are contained in the 2010 federal health care reform act?<sup>2</sup>

### 3.8% Medicare contribution tax on unearned income

The questions about the 3.8% Medicare contribution tax on unearned income are prompted by misinformation circulating on the Internet and elsewhere describing the new tax as a "sales tax" on home sales. While it is possible for the new tax to be triggered by a home sale, the information in question is wrong on the tax calculation and its impact on homeowners.

The new federal tax applies to individuals, estates, and trusts. I have limited my comments here to individuals because of the focus on homeowners.<sup>3</sup>

**Tax calculation—** In the case of individuals, the tax will be 3.8% of the *lesser* of:

1. net investment income *or*
2. the excess of adjusted gross income<sup>4</sup> over a threshold amount.

This tax is in addition to any federal income tax on the income.

<sup>1</sup> Internal Revenue Code § 1411, added by the Health Care and Education Reconciliation Act (P.L. 111-52).

<sup>2</sup> Patient Protection and Affordable Care Act (P.L. 111-148), as amended by the Health Care and Education Reconciliation Act (P.L. 111-52).

<sup>3</sup> Except for certain tax-exempt and charitable trusts, the tax applies to estates and trusts; however, there are differences in how net investment income, adjusted gross income, and the threshold amount are determined.

<sup>4</sup> The law refers to modified adjusted gross income, which is adjusted gross income calculated in the usual manner plus the amount of any income excluded under the foreign earned income exclusion rules (net of any deductions and exclusions disallowed with respect to the foreign earned income).

**Net investment income**—The new tax applies only to net investment income. This is nonbusiness income in the form of interest, dividends, annuities, royalties, rents, and gains from the sale or exchange of nonbusiness property, less allowable deductions (e.g., rental expenses).<sup>5</sup> Net investment income does not include income items that federal income tax law excludes from gross income.

**Threshold amount**—The tax does not apply unless an individual's adjusted gross income exceeds a threshold amount of \$200,000, if single, or \$250,000, if married filing jointly.<sup>6</sup>

**Application to home sale**—As already stated, the new tax does not apply to income that is excluded from gross income. Federal income tax law provides an exclusion to qualified individuals who sell their homes. Up to \$250,000 (or \$500,000, if married filing jointly)<sup>6</sup> of gain from the sale of a home is exempt from income tax in the case of individuals who owned and used the home as their principal residence for at least two years during the five-year period ending on the date of sale.<sup>7</sup>

**Example**—Following is an example of a married couple who sell their home and qualify for the principal residence exclusion.

Wages .....	\$ 240,000
Taxable interest and dividends .....	15,000
Home sale—	
Sales price .....	\$ 850,000
Cost .....	(350,000)
Gain .....	\$ 500,000
Principal residence exclusion .....	(500,000)
Taxable gain .....	0
Adjusted gross income .....	<u>\$ 255,000</u>

**Medicare contribution tax calculation—**

1. Net investment income	\$ 15,000
2. (a) AGI	\$ 255,000
(b) Threshold	(250,000)
(c) Excess AGI	\$ 5,000
3. Lesser of line 1 or line 2(c)	\$ 5,000
4. Tax: Line 3 x 3.8%	\$ 190

Additional examples of how the new tax is calculated are shown in an attachment to my testimony.

<sup>5</sup> Two types of business income are included in "net investment income": income from a trade or business that is a passive activity under the passive activity loss (PAL) rules and income from a trade or business involved in trading financial instruments or commodities. Also, income, gain, or loss that a business derives from investing its idle funds (working capital) will be treated as nonbusiness income, which means it is included in net investment income for purposes of the tax.

<sup>6</sup> \$125,000 for married persons filing separately.

<sup>7</sup> I.R.C. § 121. In addition, the individual must not have used the exclusion for another sale in the two years before the current sale. There is no limit on the number of times an individual may use the exclusion so long as the individual satisfies the conditions with respect to each sale. If any of the two-year conditions are not met, a reduced exclusion may be allowed if the sale is due to a change in place of employment, health, or unforeseen circumstances.

**Conclusion—**The new Medicare contribution tax is not a “sales tax” on homes. Rather, it is a tax on certain investment income, which could include a gain from the sale of a home. Home sale gains that are excluded from federal income tax will neither trigger the new Medicare contribution tax nor be subject to it.

Given the parameters on the tax, an individual would pay the new tax on the gain from the sale of a home *only if* :

1. the individual’s adjusted gross income exceeds \$200,000 (\$250,000, if married filing jointly), *and*
2. part or all of the gain from the sale is not excluded under the principal residence exclusion rules.

Because the principal residence exclusion rules already exempt the vast majority of home sale gains from federal income tax, very few homeowners will have to pay the new Medicare tax solely on account of selling their homes.

### **Other tax provisions in the 2010 federal health care reform act**

The Tax Department was asked to also provide the Committee with information on the other tax provisions contained in the federal health care reform law. Borrowing from a document our office prepared and presented to the Interim Industry, Business, and Labor Committee in May of 2010, I prepared a document that summarizes those federal tax provisions. Part 1 of the document contains a chart listing the various tax provisions and showing the year they take effect. Part 2 of the document contains a brief summary of each provision.

### **Conclusion**

That concludes my presentation, Mr. Chairman. If there are any questions from the Committee, I would be happy to address them at this time.

## Examples of the federal 3.8% Medicare contribution tax

### Example 1

A married couple has combined wages of \$100,000. They sell their home for \$400,000. They bought the home for \$260,000. Their gain on the sale is \$140,000 (\$400,000 - \$260,000). They qualify for the principal residence exclusion.

Wages		\$ 100,000
Home sale—		
Gain	\$ 140,000	
Exclusion	<u>(500,000)</u>	
Taxable gain		<u>0</u>
Adjusted gross income		<u><u>\$ 100,000</u></u>

Tax calculation—		
1.	Net investment income	\$ 0
2.	(a) AGI	\$ 100,000
	(b) Threshold (MFJ)	<u>(250,000)</u>
	(c) Excess AGI	\$ 0
3.	Lesser of line 1 or line 2(c)	\$ 0
4.	Tax: Line 3 x 3.8%	\$ 0

### Example 2

A married couple has combined wages of \$100,000. They sell their home for \$700,000. They bought the home for \$60,000. Their gain on the sale is \$640,000 (\$700,000 - \$60,000). They qualify for the principal residence exclusion.

Wages		\$ 100,000
Home sale—		
Gain	\$ 640,000	
Exclusion	<u>(500,000)</u>	
Taxable gain		<u>140,000</u>
Adjusted gross income		<u><u>\$ 240,000</u></u>

Tax calculation—		
1.	Net investment income	\$ 140,000
2.	(a) AGI	\$ 240,000
	(b) Threshold (MFJ)	<u>(250,000)</u>
	(c) Excess AGI	\$ 0
3.	Lesser of line 1 or line 2(c)	\$ 0
4.	Tax: Line 3 x 3.8%	\$ 0

### Example 3

A married couple has combined wages of \$260,000. They sell their home for \$1.2 million. They bought the home for \$500,000. Their gain on the sale is \$700,000 (\$1,200,000 - \$500,000). They qualify for the principal residence exclusion.

Wages		\$ 260,000
Home sale—		
Gain	\$ 700,000	
Exclusion	<u>(500,000)</u>	
Taxable gain		<u>200,000</u>
Adjusted gross income		<u><u>\$ 460,000</u></u>

Tax calculation—		
1.	Net investment income	\$ 200,000
2.	(a) AGI	\$ 460,000
	(b) Threshold (MFJ)	<u>(250,000)</u>
	(c) Excess AGI	\$ 210,000
3.	Lesser of line 1 or line 2(c)	\$ 200,000
4.	Tax: Line 3 x 3.8%	\$ 7,600



### Example 4

A married couple has combined wages of \$400,000. They sell their vacation home for \$1.2 million. They bought the home for \$500,000. Their gain on the sale is \$700,000 (\$1,200,000 - \$500,000). Because the vacation home is not their principal residence, they do not qualify for the principal residence exclusion.

Wages	\$	400,000
Home sale—		
Gain	\$	700,000
Exclusion		(0)
Taxable gain		<u>700,000</u>
Adjusted gross income	\$	<u><u>1,100,000</u></u>

Tax calculation—		
1.	Net investment income	\$ 700,000
2.	(a) AGI	\$ 1,100,000
	(b) Threshold (MFJ)	<u>(250,000)</u>
	(c) Excess AGI	\$ 850,000
3.	Lesser of line 1 or line 2(c)	\$ 700,000
4.	Tax: Line 3 x 3.8%	\$ 26,600

### Example 5

A married couple has combined wages of \$260,000, taxable interest and dividend income of \$50,000, and net rental income of \$45,000. One of the spouses also has net income of \$25,000 from a business. They do not engage in any transactions involving the sale of real estate.

Wages	\$	260,000
Interest and dividends		50,000
Net rental income		45,000
Business net income		<u>25,000</u>
Adjusted gross income	\$	<u><u>380,000</u></u>

Tax calculation—		
1.	Net investment income	\$ 95,000
2.	(a) AGI	\$ 380,000
	(b) Threshold (MFJ)	<u>(250,000)</u>
	(c) Excess AGI	\$ 135,000
3.	Lesser of line 1 or line 2(c)	\$ 95,000
4.	Tax: Line 3 x 3.8%	\$ 3,610

### Example 6

A married couple has combined wages of \$35,000, tax-exempt municipal bond interest income of \$1,500, taxable interest and dividends of \$2,500, and taxable pension benefits of \$45,000. They sell their home for \$260,000. They bought the home for \$50,000. Their gain on the sale is \$210,000 (\$260,000 - \$50,000). They qualify for the principal residence exclusion.

Wages	\$	35,000
Interest and dividends		2,500
Pension benefits		45,000
Home sale—		
Gain	\$	210,000
Exclusion		<u>(500,000)</u>
Taxable gain		<u>0</u>
Adjusted gross income	\$	<u><u>82,500</u></u>

Tax calculation—		
1.	Net investment income	\$ 2,500
2.	(a) AGI	\$ 82,500
	(b) Threshold (MFJ)	<u>(250,000)</u>
	(c) Excess AGI	\$ 0
3.	Lesser of line 1 or line 2(c)	\$ 0
4.	Tax: Line 3 x 3.8%	\$ 0



## Federal Health Care Reform: Summary and Timeline of Tax Changes

### Introduction

This document provides a summary and timeline of the federal tax provisions contained in the Patient Protection and Affordable Care Act (PPACA; P.L. 111-148), as amended by the Health Care and Education Reconciliation Act of 2010 (HCERA; P.L. 111-152). Part 1 provides a list of the tax-related provisions and shows when they become effective. Part 2 provides additional general information about each of the provisions listed in Part 1.

This document was prepared by the North Dakota Office of State Tax Commissioner using information derived from Thomson Reuters™ Checkpoint®. It is only intended as a general reference. The Internal Revenue Code, Treasury regulations, Internal Revenue Service rulings, etc., as well as any changes and developments in them, must be consulted for complete details.

Part 1 – List of Tax-Related Provisions	Year										
	"x" indicates first year provision applies White spaces indicate years in which provision applies										
	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Post-2018
1. Tax credit for qualifying therapeutic discovery projects	x										
2. Income exclusion for state student loan repayment or loan forgiveness programs for health professionals	x										
3. New qualification requirements for nonprofit hospitals		x									
4. Tax on tanning services		x									
5. Tax credit for small employers who provide health insurance to employees—											
o 35% of premiums paid by employer		x									
o 50% of premiums paid by employer (through state exchange)						x					
6. Extension of health coverage for dependent child through age 26		x									
7. Increased penalties for underpayment of tax due to tax benefit based on transaction lacking economic substance		x									
8. Expansion of adoption credit and exclusion for employer-provided adoption assistance		x									
9. Elimination of tax breaks for health organizations with medical loss ratio below 85%		x									
10. Tighter qualification rules for cellulosic biofuel producer tax credit		x									
11. Reporting of employer-provided health insurance cost on employee's Form W-2			x								



Part 1 – List of Tax-Related Provisions		Year										
		"x" indicates first year provision applies White spaces indicate years in which provision applies										
		2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Post-2018
12.	Limitation on over-the-counter medications for health expense account reimbursement			X								
13.	Higher "additional" tax on nonqualifying distributions from HSA and MSA			X								
14.	Tax on drug manufacturers selling branded prescription drugs to government programs			X								
15.	Simple cafeteria plans for small employers			X								
16.	Information reporting for business payments to corporations	Repealed in 2011 before it would have taken effect in 2012										
17.	0.9% Medicare tax on certain wages and self-employment income					X						
18.	3.8% Medicare tax on unearned income of individuals, estates, and trusts					X						
19.	Higher adjusted gross income threshold for medical expenses for itemizers					X						
20.	Limit on employee's contributions to an employer-sponsored health FSA					X						
21.	Reduced deduction for retiree drug coverage subsidy received by drug plan sponsor					X						
22.	Fee on health plans to finance Patient-Centered Outcomes Research Trust Fund					X						
23.	Limit on compensation deduction for health insurance providers					X						
24.	Tax on medical device manufacturers, producers and importers					X						
25.	Assessment payment ("excise tax") on large employers that do not offer affordable or minimum value benefit health insurance coverage						X					
26.	Health insurance requirement for individuals and related penalty tax						X					
27.	Employers offering health insurance must provide "free choice" vouchers to employees						X					
28.	Refundable tax credit for low- or moderate-income families to offset cost of Exchange-purchased health insurance						X					
29.	Health plan premium reimbursement benefit under employer-maintained cafeteria plan						X					
30.	New information reporting requirements for employers providing health coverage						X					
31.	Tax on health insurance providers						X					
32.	Estimated income tax payments accelerated for large corporations						X					
33.	Excise tax on high-cost employer-provided health insurance coverage										X	



## Part 2 – Summary of Tax-Related Provisions in Part 1

### 1. Tax credit for qualifying therapeutic discovery projects

A 50% nonrefundable investment tax credit for qualified investments in qualifying therapeutic discovery projects is allowed to businesses with up to 250 employees. 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 either (1) conducting pre-clinical activities, clinical trials, clinical studies, and research protocols or (2) developing technology or products designed to diagnose diseases and conditions, including molecular and companion drugs and diagnostics, or to further the delivery or administration of therapeutics. \$1 billion is allocated to such projects in the 2009 and 2010 tax years

**Law:** I.R.C. § 48D; effective for expenses paid or incurred in tax years 2009 and 2010 only.

### 2. Income exclusion for state student loan repayment or loan forgiveness programs for health professionals

The gross income exclusion for amounts received under the National Health Service Corps loan repayment program or certain State loan repayment programs (described in Section 338I of the Public Health Service Act) is modified to include any amount received by an individual under any State loan repayment or loan 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).

**Law:** I.R.C. § 108(f)(4), effective for loan repayments (constituting income to the individual) made in tax years 2009 and after.

### 3. New qualification requirements for nonprofit hospitals

New qualification requirements apply to any Code Sec. 501(c)(3) organization that operates at least one hospital facility. These requirements include: conducting, implementing and widely publicizing a community health needs assessment; adopting and implementing a written financial assistance policy; and adopting and implementing a nondiscriminatory policy to provide emergency medical treatment to individuals.

**Law:** I.R.C. §§ 501(r) and 6033(b), effective for tax years beginning on or after March 24, 2010.

### 4. Tax on tanning services

A 10% excise tax is imposed on indoor tanning services, whether paid for by insurance or otherwise. The tax is imposed on tanning service recipients (although the provider is secondarily liable).

**Law:** I.R.C. § 5000B(a), effective for tanning services performed on or after July 1, 2010.

### 5. Tax credit for small employers who provide health insurance to employees

For tax years 2010 through 2013 only, a tax credit is allowed for 35% of an employer's nonelective contributions to employees' health insurance premiums. For tax years 2014 and after, a tax credit is allowed for two years for 50% of employer's nonelective contributions to employees' health insurance premiums if the employer purchases health insurance through a state exchange. The full credit is allowed to an employer with up to 10 full-time equivalent employees (FTEEs), for which the average annual full-time equivalent wage is less than \$25,000. The credit phases out as the number of FTEEs and average annual full-time equivalent wages increase, completely phasing out when the number of FTEEs exceeds 25 and the average annual full-time equivalent wages exceed \$50,000. Sole proprietors (including employed family members), partners, 2% "S" corporation shareholders, and 5% owners are not employees for purposes of the credit.

**Law:** I.R.C. § 45R, effective for tax years 2010 and after.

### 6. Extension of health coverage for dependent child through age 26

The exclusion from income of reimbursements for medical care expenses under an employer-provided accident or health plan is extended to any child of an employee who hasn't attained age 27 as of the end of the tax year. This also applies for voluntary employees' beneficiary associations (VEBAs) and for qualified pension and annuity plans providing accident and sickness benefits. Self-employed individuals are allowed to deduct health insurance costs of any child of the taxpayer who has not attained age 27 as of the end of the tax year.

**Law:** I.R.C. §§ 105(b), 501(c)(9), 401(h), and 162(l)(1)(D), effective March 30, 2010.

### 7. Increased penalty for underpayment of tax due to tax benefit based on transaction lacking economic substance

The economic substance doctrine (applicable to transactions generating tax benefits) is clarified and enhanced by way of a new uniform definition. For a transaction to which the economic substance doctrine is relevant, the transaction has economic substance only if, apart from federal income tax effects, the transaction changes in a meaningful way the taxpayer's economic position and the taxpayer has a substantial purpose for entering into the transaction. New and increased penalties apply if tax is underpaid due to a transaction lacking economic substance.

**Law:** I.R.C. §§ 7701(o)(1), 6662(b)(6), 6662(i)(1), 6676(c), and 162(l)(1)(D), effective for transactions, underpayments, understatements, and refunds and credits attributable to transactions entered into after March 30, 2010.



**8. Expansion of adoption credit and exclusion for employer-provided adoption assistance**

The maximum amount of the adoption credit is increased to \$13,170 per eligible child (a \$1,000 increase) for both non-special needs adoptions and special needs adoptions, and the credit is made refundable. The maximum exclusion for employer-provided adoption assistance is increased to \$13,170 per eligible child (a \$1,000 increase).

**Law:** I.R.C. §§ 36C, 137, and 162(l)(1)(D), effective for tax years 2010 and 2011 only; credit and exclusion sunset after 2011 (special needs adoption credit does not sunset but is reduced to \$6,000).

**9. Elimination of tax breaks for health organizations with medical loss ratio below 85%**

Nonprofit Blue Cross Blue Shield organizations must maintain a medical loss ratio of 85% or higher in order to take advantage of the special tax benefits provided to them, including the deduction for 25% of claims and expenses and the 100% deduction for unearned premium reserves.

**Law:** I.R.C. § 833(c)(5), effective for tax years 2010 and after.

**10. Tighter qualification rules for cellulosic biofuel producer tax credit**

The cellulosic biofuel producer credit is not allowed for fuel with significant water, sediment, or ash content, such as "black liquor." This is a fuel that is more than 4% (determined by weight) water and sediment in any combination or has an ash content of more than 1% (determined by weight).

**Law:** I.R.C. § 40(b)(6)(E), effective for fuels sold or used on or after January 1, 2010.

**11. Reporting of employer-provided health insurance cost on employee's Form W-2**

An employer must disclose on each employee's annual Form W-2 the value of the employee's health insurance coverage sponsored by the employer, including dental, vision, and other separate health insurance coverage.

**Law:** I.R.C. § 6051(a)(14), effective for tax years 2011 and after.

**12. Limitation on eligibility of over-the-counter medications for health expense account reimbursement**

Unless prescribed by a physician, the cost of over-the-counter medications may not be reimbursed through a health flexible spending arrangement (FSA), health reimbursement account (HRA), health savings account (HSA), or Archer Medical Savings Account (MSA).

**Law:** I.R.C. § 106(f), 220(d)(2)(A), and 223(d)(2)(A), effective for HSA and Archer MSA, amounts paid with respect to tax years 2011 and after; for health FSA and HRA, expenses incurred with respect to tax years 2011 and after.

**13. Higher "additional" tax on nonqualifying distributions from HSA and MSA**

- The additional tax on distributions from a Health Savings Account (HSA) not used to pay qualified medical expenses is increased from 10% to 20% of the disbursed amount.
- The additional tax on distributions from an Archer Medical Savings Account (MSA) not used to pay qualified medical expenses is increased from 15% to 20% of the disbursed amount.
- This additional tax on distributions not used for qualified medical expenses does not apply if the distribution is made after death, disability, or attainment of age of Medicare eligibility.

**Law:** I.R.C. §§ 220(f)(4)(A) and 223(f)(4)(A), effective for disbursements made in tax years 2011 and after.

**14. Tax on drug manufacturers and importers that sell branded prescription drugs to specified government programs**

- An annual nondeductible excise tax must be paid by a manufacturer or importer of branded prescription drugs that receives gross income from the sale of the drugs to, or pursuant to coverage under, Medicare Parts B and D, Medicaid, Dept. of Veterans' Affairs, Dept. of Defense, and the TRICARE pharmacy program.
- The amount of the tax, which is apportioned among affected businesses based on their respective share of the total branded prescription drug sales during the preceding calendar year, is \$2.5 billion for 2011; \$2.8 billion for 2012 and 2013; \$3 billion for 2014 through 2016; \$4 billion for 2017; \$4.1 billion for 2018; and \$2.8 billion for 2019 and after.
- The amount of gross receipts from sales included in the apportionment calculation is 0% on first \$5 million; 10%, over \$5 million but no more than \$125 million; 40%, over \$125 million but no more than \$225 million; 75%, over \$225 million but no more than \$400 million; and 100%, over \$400 million.

**Law:** P.L. 111-148, Sec. 9008, effective for calendar years 2011 and after.

**15. Simple cafeteria plans for small employers**

An employer having an average of 100 or fewer employees on business days during either of the two preceding tax years may provide employees with a "simple cafeteria plan." The employer is provided with a safe harbor from the nondiscrimination requirements for cafeteria plans as well as from the nondiscrimination requirements for specified qualified benefits offered under a cafeteria plan, including group term life insurance, benefits under a self-insured medical expense reimbursement plan, and benefits under a dependent care assistance program.

**Law:** I.R.C. § 125(j), effective for tax years 2011 and after.



**16. Information reporting for business payments to corporations (Note: This provision was repealed in 2011 before it took effect.)**

Had this provision taken effect, it would have required a person engaged in a trade or business to file an information return (Form 1099) for payments of income, which are made in the course of the payor's trade or business, aggregating \$600 or more during the calendar year to a corporate provider of property or services.

**Law:** I.R.C. § 6041(h). Repealed before it took effect by PL 112-9, Sec. 2(a), 4/14/2011. (Would have applied to payments made on or after January 1, 2012.)

**17. 0.9% Medicare tax on certain wages and self-employment income**

- The Medicare hospital insurance tax (HI) portion of the FICA tax withheld from an employee's wages, currently 1.45%, increases by 0.9% to 2.35% on the amount of wages exceeding \$250,000 for married persons filing jointly, \$125,000 for married persons filing separately, and \$200,000 in all other cases. The employer's matching HI tax is not increased by the 0.9%. (Note: An employer is only required to withhold the additional 0.9% on wages in excess of \$200,000 paid to an employee regardless of how the employee files or other wages of the employee or the employee's spouse.)
- The Medicare hospital insurance tax (HI) portion of the SECA tax on self-employment income, currently 2.9%, increases by 0.9% to 3.8% on the amount of taxable self-employment income exceeding the same thresholds shown above.

**Law:** I.R.C. §§ 3101(b)(2) and 1401(b)(2), effective for tax years 2013 and after.

**18. 3.8% Medicare tax on unearned income of individuals, estates, and trusts**

- A Medicare contribution tax must be paid by individuals having unearned income in excess of the following modified adjusted gross income amounts: \$250,000, if married filing jointly, \$200,000, if single, or \$125,000, if married filing separately.
- For an individual, the tax is 3.8% of the lesser of (1) net investment income or (2) the excess of modified adjusted gross income over the applicable threshold amount.
- Net investment income means interest, dividends, annuities, royalties, rents, and capital gains not attributable to a business reduced by allowable deductions (e.g., rental expenses). However, net income from a business is included if the business is a passive activity or is engaged in trading financial instruments or commodities. Investment income does not include distributions from qualified retirement plans or any income item excluded from gross income, such interest on tax-exempt bonds or gain excluded under the principal residence exclusion.
- Modified adjusted gross income means adjusted gross income computed in the regular manner increased by any foreign earned income excluded from gross income.
- For an estate or trust, the tax is 3.8% of the lesser of (1) undistributed net investment income or (2) the excess of adjusted gross income over the dollar amount at which the highest income tax bracket begins.

**Law:** I.R.C. § 1411, effective for tax years 2013 and after.

**19. Higher adjusted gross income threshold for medical expenses for itemizers**

Only unreimbursed medical expenses in excess of 10% of adjusted gross income are deductible as an itemized deduction. For tax years 2013 through 2016 only, the medical expense threshold remains at 7.5% if the individual or the individual's spouse age 65 or older. The 10% medical expense threshold applies to 65-year old individuals in tax years 2017 and after.

**Law:** I.R.C. §§ 213(a) and 213(f), effective for tax years 2013 and after.

**20. Limit on employee's contributions to an employer-sponsored health FSA**

To be a qualified (i.e., nontaxable) benefit in an employer-sponsored cafeteria plan, a health flexible spending account must limit employee contributions through salary reduction to no more than \$2,500 for the plan year. (Note: Indexed after 2013.)

**Law:** I.R.C. §§ 125(i) and 213(f), effective for tax years 2013 and after.

**21. Reduced deduction for retiree drug coverage subsidy received by drug plan sponsor**

Currently, qualified retiree prescription drug plan subsidies that plan sponsors receive from the Secretary of Health and Human Services to offset part of the sponsor's drug costs are nontaxable, and the plan sponsor is allowed to deduct the total drug cost (including the subsidized portion). The revised law requires the deduction for retiree prescription drug expenses to be reduced by the subsidy amount.

**Law:** I.R.C. § 139A, effective for tax years 2013 and after.

**22. Fee on health plans to finance Patient-Centered Outcomes Research Trust Fund**

A health insurance provider or a sponsor of a self-insured health plan must pay a fee on each health insurance policy or self-insured health plan equal to an amount determined by multiplying \$2.00 (\$1.00 for policy years ending during 2013) by the average number of lives covered under the policy or plan. For a policy year ending in any fiscal year beginning after Sept. 30, 2014, the fee is adjusted under a formula based on the percentage increase in the projected per capita amount of National Health Expenditures published by the Secretary of Health and Human Services. Fee revenue will be used to finance the Patient-Centered Outcomes Research Trust Fund established to carry out the provisions of the Health Care Act relating to comparative clinical effectiveness research.

**Law:** I.R.C. §§ 4375, 4376, and 4377, effective for plan policy years ending after September 30, 2012, and before October 1, 2019.

**23. Limit on compensation deduction for health insurance providers**

A health insurance provider may not deduct more than \$500,000 of compensation paid to an officer, employee, director, and any other worker or service provider, e.g., a consultant. Under a complex rule, this limitation may reach back and apply to compensation for services performed in tax years 2010 through 2012.

**Law:** I.R.C. § 162(m)(6)(A), effective for tax years 2013 and after.



#### 24. Tax on medical device manufacturers, producers and importers

A 2.3% excise tax applies to the sale of a medical device as defined under the Federal Food, Drug, and Cosmetic Act that is intended for humans. The excise tax applies to an instrument, apparatus, implement, machine, contrivance, implant, in vitro reagent, or other similar article, including any component, part, or accessory, that meets any of the following: (1) It is recognized in the official National Formulary or the U.S. Pharmacopeia; (2) It is intended for use in the diagnosis, cure, mitigation, treatment, or prevention of disease; or, (3) It is intended to affect the structure or function of the body, but does not achieve its intended purpose through chemical action or metabolism. The excise tax does not apply to eyeglasses, contact lenses, hearing aids, and any other medical device determined by the Internal Revenue Service to be of a type that is generally purchased by the general public at retail for individual use. The sale of an otherwise taxable medical device is exempt from the excise tax if sold for further manufacture or export.

**Law:** I.R.C. § 4191, effective for sales in tax years 2013 and after.

#### 25. Assessment payment ("excise tax") on large employers that do not offer affordable or minimum value benefit health insurance coverage

- A nondeductible assessment payment ("excise tax" or "penalty tax") must be paid by a large employer if both of the following conditions apply:
  - (1) The employer (a) does not offer health coverage for all of its full-time employees, (b) offers health coverage that is unaffordable for one or more of its full-time employees, or (c) offers health coverage that pays less than 60% of the cost of allowed benefits. "Unaffordable" means the annual premium payable by the employee is more than 9.5% of the employee's household income.
  - (2) At least one full-time employee purchases health insurance through an exchange for which the employee qualifies for the premium tax credit or cost-sharing reduction.
- A large employer is one that employs an average of at least 50 full-time employees on business days in the preceding calendar year.
- For a large employer not offering health coverage, the tax for each month is equal to \$166.67 (1/12th of \$2,000) multiplied by the number of full-time employees in excess of 30.
- For a large employer offering health coverage that is either unaffordable or does not pay at least 60% of the cost of allowed benefits, the tax for each month is equal to the lesser of the following:
  - (1) \$250.00 (1/12th of \$3,000) multiplied by the number of full-time employees receiving a premium tax credit or cost-sharing reduction (excluding a "free choice voucher"—see item 27).
  - (2) \$250.00 (1/12th of \$3,000) multiplied by the number of full-time employees in excess of 30.

**Law:** I.R.C. § 4980H, effective for months beginning on or after January 1, 2014.

#### 26. Health insurance requirement for individuals and related penalty tax

**Note:** On June 28, 2012, the U.S. Supreme Court, in *National Federation of Independent Business v. Sebelius*, by a margin of 5-4, largely upheld the Patient Protection and Affordable Care Act, including the individual mandate. The majority opinion concluded that the mandate is a valid exercise of Congress's taxing power. The Court also held that the Act's expansion of Medicaid is constitutional; however, Congress cannot penalize non-participating states by taking away their existing Medicaid funding. The other provisions of the Act were left intact.

- Unless exempted, a citizen or legal resident of the U.S. must maintain health insurance coverage or pay a penalty.
- Health insurance coverage includes government sponsored programs (e.g., Medicare, Medicaid, Children's Health Insurance Program), employer-sponsored plans, private plans in the individual market, certain grandfathered group health plans and other coverage recognized by Health and Human Services (HHS) in coordination with IRS.
- The following individuals are exempt from this requirement:
  - (1) In general, individuals who cannot afford coverage because their required contribution for employer-sponsored coverage or the lowest cost "bronze plan" in the local Insurance Exchange exceeds 8% of household income for the year.
  - (2) Individuals with income below the income tax filing threshold (Note: For 2012, the filing threshold is \$9,750, if single; \$12,500, if head of household; \$19,500, if married filing jointly; and \$9,750, if married filing separately).
  - (3) Individuals who are members of a recognized religious sect claiming exemption from the self-employment tax.
  - (4) Individuals residing outside of the U.S. who either qualify for the foreign earned income exclusion or are bona fide residents of U.S. possessions.
  - (5) Incarcerated individuals.
  - (6) Members of Indian tribes.
  - (7) Individuals granted a hardship exemption by Health and Human Services.
- The penalty, which is calculated per household, is equal to the greater of (1) a flat dollar amount per uninsured person in the household (see table below) or (2) a percentage of household income in excess of the amount of income that triggers the filing of an income tax return (see table below). After 2016, the flat dollar amount is indexed for inflation. For individuals under age 18, the flat dollar amount is one-half the adult amount. The maximum penalty per household is 300% of the applicable per adult flat dollar amount.

**Law:** I.R.C. § 5000A, effective for tax years 2014 and after.



**27. Employers offering health insurance must provide “free choice” vouchers to eligible employees**

- An employer offering health insurance coverage through an employer-sponsored plan and paying a portion of that coverage must provide qualified employees with a “free choice” voucher, the value of which can be applied to the purchase of a health plan through the Insurance Exchange.
- A qualified employee is one who (1) does not participate in the employer-sponsored plan, (2) has a total household income that does not exceed 400% of the poverty line, and (3) would have had to contribute to the cost of the employer-sponsored health coverage an amount over 8% but not over 9.8% of household income if the employee had chosen to participate. (Note: After 2014, the 8% and 9.8% thresholds will be indexed to reflect the rate of premium growth over income growth between the preceding calendar year and 2013.)
- In general, the value of the “free choice” voucher is equal to the monthly portion of the cost of the employer-sponsored health plan which would have been paid by the employer if the employee were covered under the plan. If the voucher’s value exceeds the premium for the health plan chosen by the employee, the excess value is paid to the employee. The excess amount paid to the employee is includible in the employee’s gross income. To the extent the voucher’s value is applied to the cost of the chosen health plan, that amount is not taxable to the employee. The voucher’s value is a deductible expense to the employer as compensation for personal services.
- An employee who receives a voucher is not eligible for the premium tax credit or cost-sharing reduction for the purchase of a plan in the Insurance Exchange, and the employer is not subject to the large employer excise tax for the employee.

**Law:** PPACA Sec. 10108(F)(1), effective for vouchers issued on or after January 1, 2014.

**28. Refundable tax credit for low- or moderate-income families to offset cost of Exchange-purchased health insurance**

- A refundable tax credit (called the “premium assistance tax credit”) is available to a qualifying individual to help reduce the cost of health insurance coverage obtained by enrolling in a qualified health plan (QHP) through a state-established “American Health Benefit Exchange.”  
*Note: Each state is required to establish an Exchange by January 1, 2014, and insurance providers are required to provide QHPs for sale on the Exchanges. The Exchange is not an insurer but will provide access to insurers’ QHPs in a comparable manner.*
- A qualifying individual generally is an individual whose household income is at least 100% but not more than 400% of the federal poverty line and who does not receive health insurance under an employer plan.
- In general, the tax credit for a tax year is equal to a percentage of the amounts paid for QHP coverage for the individual and qualifying family members for the year. The percentage is based on the individual’s household income level relative to the federal poverty line.

- In general, an qualifying individual will enroll in a plan offered through an Exchange and report his or her income to the Exchange which, in turn, determines the amount of the tax credit. The IRS will submit a payment for the amount of the tax credit directly to the insurance plan in which the individual is enrolled. The individual submits a payment to the plan equal to the difference between the tax credit and the total premium due for the plan. For employed individuals who purchase health insurance through an Exchange, the premium payments will be made through payroll deductions. Initial eligibility for the premium assistance credit will be based on the individual’s income for the tax year ending two years before the enrollment period.
- A cost-sharing reduction is available to an individual who receives a tax credit. The cost-sharing (i.e., the deductibles, co-payments, etc.) required under a QHP will be reduced for individuals at or below 400% of the poverty line. The standard out-of-pocket maximum limits will be reduced by two-thirds for individuals with household income of more than 100% but not more than 200% of the poverty line, by one-half for individuals between 201% and 300% of the poverty line, and by one-third for individuals between 301% and 400% of the poverty line.

**Law:** I.R.C. § 36B, effective for tax years ending after December 31, 2013 (*Note: This generally applies to tax years 2014 and after because most individuals’ tax years run from January 1 through December 31; however, this effective date also makes the credit available to individuals with a fiscal year beginning in 2013 and ending in 2014, i.e., their 2013 tax year.*)

**29. Health plan premium reimbursement benefit under employer-maintained cafeteria plan**

- For a qualified employer, a reimbursement for the premiums paid for coverage under a qualified health plan obtained through an Exchange is a qualified benefit under a cafeteria plan.
- Prior to 2017, a “qualified employer” is limited to one that is a small employer, which employed an average of at least one but not more than 100 employees on business days during the preceding calendar year, and employs at least one employee on the first day of the plan year and (2) elects to make all of its full-time employees eligible for one or more qualified health plans offered in the “small group market” through an Exchange that offers qualified health plans.
- Beginning in 2017, a “qualified employer” will also include one that (1) is a large employer, which employed an average of at least 101 employees on business days during the preceding calendar year, and employs at least one employee on the first day of the plan year and (2) elects to make all of its full-time employees eligible for one or more qualified health plans offered in the “large group market” through an Exchange (This assumes the state allows insurance providers to offer qualified health plans in the “large group market” through an Exchange.)
- A “group market” is the health insurance market under which individuals obtain health insurance coverage through a group health plan maintained by an employer. “Large group markets” contain the group health plans maintained by large employers. “Small group markets” contain the group health plans maintained by small employers.



- o Broadly, a “qualified health plan” is one that meets certain certification requirements, provides “an essential health benefits package,” and is offered by a qualified insurer.

**Law:** I.R.C. § 125(f)(3)(B), effective for tax years 2014 and after.

### **30. New information reporting requirements for employers providing health coverage**

- o New information reporting requirements apply to (1) large employers required to offer their full-time employees health coverage under an employer-sponsored plan (i.e., employers subject to the excise tax or “penalty” for not offering affordable or minimum value coverage) and (2) employers paying any portion of the cost of health coverage offered to its employees through an employer-sponsored plan, under which the portion of the annual premium paid by any individual employee for self-only coverage exceeds 8% of the employee's wages.
- o The essential information required to be reported includes (1) employer's identity; (2) certification as to whether the employer offers health coverage to its full-time employees and their dependents under an employer-sponsored plan; (3) number of full-time employees for each month during the calendar year; (4) identity of each full-time employee and the number of months, if any, during which the employee was covered under a plan sponsored by the employer during the calendar year; and (5) any other information yet to be determined by the IRS.

**Law:** I.R.C. § 6056, effective for periods beginning on or after January 1, 2014.

### **31. Tax on health insurance providers**

- o Businesses that provide health insurance covering U.S. health risks must pay a share of an annual nondeductible excise tax.
  - (1) The excise tax does not apply to governmental entities, certain nonprofits, or organizations that qualify as a VEBA that are established by an entity other than an employer, e.g., a union.
  - (2) For purposes of the tax, health insurance does not include (a) coverage only for a specified disease or illness, (b) hospital indemnity or other fixed indemnity insurance, (c) insurance for long-term care, or (d) Medicare supplemental health insurance.
- o The amount of the annual excise tax, which is apportioned among affected businesses based on their respective share of the total net premiums written during the preceding calendar year for U.S. risk health insurance is \$8 billion for 2014; \$11.3 billion for 2015 and 2016; \$13.9 billion for 2017; \$14.3 billion for 2018; and an amount indexed for the rate of premium growth for 2019 and after. The amount of net premiums written during the calendar year that are included in the apportionment calculation is 0% of the first \$25 million; 50% of net premiums over \$25 million but no more than \$50 million; and 100% of net premiums over \$50 million.

**Law:** PPACA Sec. 9010, as amended by HCERA Sections 10905 and 1406, effective for calendar years 2014 and after.

### **32. Estimated income tax payments accelerated for large corporations**

The estimated tax payment that corporations having assets of at least \$1 billion at the end of the previous tax year must pay in July, August, or September of 2014 is increased from 157.75% to 173.50% of the payment otherwise due, and the amount of the next required installment is appropriately reduced. This change accelerates revenue receipts into the U.S. government's fiscal year ending September 30, 2014, with an equivalent reduction in the revenue for the fiscal year ending in 2015. This requirement will affect only 2014 calendar year corporations, corporations with a fiscal year beginning in July, August, September, November, and December of 2013 (i.e., their 2013 tax year), and corporations with a fiscal year beginning in February, March, April, May, and June of 2014 (i.e., their 2014 tax year).

**Law:** HCERA Sec. 1410, effective for estimated tax installments due in July, August, or September of 2014.

### **33. Excise tax on high-cost employer-provided health insurance coverage**

To induce health insurers to offer policies that cost no more than annual limits set by law, a nondeductible excise tax must be paid by health insurers if (1) an employee is covered under employer-sponsored health insurance coverage, and (2) there is an excess benefit with respect to the coverage. The excise tax is 40% of the excess benefit. An excess benefit exists if the value of health insurance coverage for an employee exceeds specified threshold amounts.

- o The value of health insurance coverage for an employee equals the sum of (a) premiums for employer-sponsored health insurance coverage for the employee, (b) employee salary reduction contributions to a health flexible spending arrangement, and (c) employer contributions to a health savings account or an Archer medical savings account.
- o For 2018, the basic specified threshold amount is \$10,200 for individual coverage and \$27,500 for family coverage. However, an additional threshold amount of \$1,650 (single coverage) or \$3,450 (family coverage) is added to the basic threshold for (1) an individual who is age 55 or more, non-Medicare eligible, and receiving employer-sponsored retiree health coverage or (2) an individual covered by a employer-sponsored health plan under which the majority of covered employees are engaged either in a high risk profession—e.g., law enforcement and fire protection, construction, mining, and agriculture—or to repair or install electrical and telecommunications lines. The threshold amounts are indexed to the CPI-U starting in 2019. Other adjustment amounts also apply in determining the applicable threshold amount.

**Law:** I.R.C. § 4980I, effective for tax years 2018 and after.