

Health Care Legislation Yields Significant Tax Consequences

Following the enactment of the Patient Protection and Affordable Care Act (H.R. 3590) on March 25, 2010, Congress passed the Health Care and Education Reconciliation Act on March 26, 2010. These two pieces of health care legislation (together, the “Health Care Legislation”) add, increase, and expand important taxes.

New Unearned Income Medicare Contribution Tax on Lesser of Net Investment Income and Modified Adjusted Gross Income:

- Effective for taxable periods beginning after 2012, the Health Care Legislation imposes a new tax (called the unearned income Medicare contribution tax) of 3.8% on individuals¹ earning more than a certain “threshold amount,” which is modified adjusted gross income greater than \$200,000 for taxpayers filing individually (\$250,000 if filing jointly or \$125,000 if married and filing separately). The 3.8% tax is calculated based on the lesser of (1) net investment income, and (2) the amount that the taxpayer’s modified adjusted gross income exceeds the threshold amount.
- Significantly, (1) the threshold amounts are not indexed for inflation; (2) the tax is subject to the estimated tax provisions; and (3) the new 3.8% tax is not deductible in computing income tax liability.
- The calculation of net investment income is complex: more specifically, net investment income is investment income reduced by the deductions properly allocable to that income; and, in general, investment income is the sum of (1) gross income from interest, dividends, annuities, royalties, and rents, (2) net gain attributable to the disposition of property (other than property held in a trade or business), and (3) gross income derived from a trade or business that is a passive activity to the taxpayer or is derived from a business of trading in financial instruments or commodities.
- For example, a taxpayer filing individually with modified adjusted gross income of \$500,000 and net investment income of \$200,000 would pay the 3.8% tax on \$200,000 (resulting in a tax liability of \$7,600) rather than on \$300,000 which is the amount by which the taxpayer’s modified adjusted gross income exceeds the threshold amount.
- We expect additional guidance from the IRS in light of the potentially broad scope of this 3.8% tax.

Additional Hospital Insurance Tax:

- FICA:

Effective for employment wages received after 2012, the hospital insurance tax on wages has been increased by 0.9% from 1.45% to 2.35% for taxpayers earning more than the relevant threshold amounts described above. Taxpayers will be taxed at a rate of 2.35% on wages in excess of the threshold amount. For example, a taxpayer filing a “single” return with \$400,000 in wages would pay 1.45% on the first \$200,000 of earnings (a tax of \$2,900) and 2.35% on the remaining \$200,000 (a tax of \$4,700).

¹ Similar rules will apply to trusts and estates.

- SECA:

Self-employment wages received after 2012 will similarly be taxed at a rate of 2.9%, with a rate of 3.8% on self-employment wages in excess of the relevant threshold amounts (as above, \$200,000 if filing “single,” or \$250,000 for taxpayers filing joint returns or \$125,000 for married taxpayers filing individual returns). No deduction is allowed for this 0.9% tax.

Economic Substance Doctrine Codified:

- Many of our courts apply an “economic substance” doctrine, under which income tax benefits with respect to a transaction are disallowed if the transaction lacks economic substance. Because the courts applied this judicial doctrine somewhat inconsistently, Congress, in the Health Care Legislation, decided to (1) codify the economic substance doctrine and (2) add a new strict liability penalty for underpayments and understatements attributable to transactions lacking economic substance. A transaction will have economic substance only if the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position, and the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction. The codified doctrine generally applies to transactions entered into after the date of enactment.

New “Cadillac Plan” Excise Tax:

- The Health Care legislation imposes a new excise tax on insurers beginning in 2018 (and not in 2013 as proposed in a prior bill). The excise tax applies if the aggregate value of employer-sponsored health insurance coverage for an employee exceeds a threshold amount and imposes a 40% tax rate on such excess amount. The initial threshold amount is \$10,200 for individuals and \$27,500 for family coverage. The threshold amount is indexed for inflation in health care costs.

For more information on the combined legislation and tax matters in general, please contact your Ropes & Gray advisor.

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