KING & SPALDING

Client Alert

Tax Practice Group

August 13, 2012

ObamaCare's Impact on Expatriate Investment Fund Partners

For more information, contact:

John C. Taylor
+44 20 7551 7553
jtaylor@kslaw.com

Hap Shashy
+1 202 626 5616
hshashy@kslaw.com

Wayne Pressgrove
+1 404 572 2722
wpressgrove@kslaw.com

Sara Silverstein
+1 202 626 2646
ssilverstein@kslaw.com

King & Spalding
London
25 Old Broad Street
London EC2N 1AR
Tel: +44 20 7551 7500
Fax: +44 20 7551 7575

Washington, D.C.
1700 Pennsylvania Avenue, NW
Washington, D.C. 20006-4706
Tel: +1 202 737 0500
Fax: +1 202 626 3737

Atlanta
1180 Peachtree Street, NE
Atlanta, GA 30309-3521
Tel: +1 404 572 4600
Fax: +1 404 572 5100

www.kslaw.com

The United States Supreme Court upheld the constitutionality of the Health Care and Education Reconciliation Act of 2010 (commonly referred to as ObamaCare) in a decision released June 28, 2012. A copy of the decision *National Federation of Independent Business v. Sebelius* is available by clicking **here**.

As a result of the Supreme Court's decision, ObamaCare's individual mandate and tax provisions remain in place. This client alert focuses on the ramifications of three provisions for expatriate United States individuals who are partners in investment funds: the individual mandate, the 0.9 percent "hospital tax", and the 3.8 percent Medicare contribution tax.

For information on other key individual tax provisions enacted as part of ObamaCare, see our May 2010 client alert, which is available by clicking **here**. The key business tax provisions are summarized in the companion client alert "Business Tax Provisions of the Health Care Reform Act," which is available by clicking **here**.

Potential Application of the "Individual Mandate"

The individual mandate refers to a requirement that covered persons maintain "minimum essential coverage" for themselves, their spouses, and their dependents. Failure to have minimum essential coverage results in a penalty imposed by the Internal Revenue Code of 1986 (the Code). The penalty is called a "shared responsibility payment" but it is assessed under the Code and is accounted for as an additional amount of tax owed. The Supreme Court's decision focused on the constitutionality of this provision.

Individuals who fail to obtain minimum essential coverage will be required to pay a tax penalty each month beginning January 1, 2014. The penalty calculation is the greater of either a percentage of "applicable income" or a flat dollar amount assessed for each taxpayer and their dependents. Both the percentage and flat dollar amounts increase each year through 2016 with the applicable percentage increasing from 1 percent to 2.5 percent of applicable income. However, the penalty for noncompliance is subject to certain caps and cannot exceed the national average premium for "bronze level" qualified health plans that are required to be offered through the ObamaCare health insurance exchanges.

The individual mandate does not treat foreign health insurance the same as domestic health insurance. Even coverage under a foreign health service program, such as Britain's National Health Service, is not sufficient to avoid the penalty tax. It is unclear whether foreign employer provided health insurance would qualify. It is less clear whether individually purchased foreign health insurance is sufficient. ObamaCare permits the Secretary of Health and Human Services (HHS), in coordination with Internal Revenue Service (the Service), to recognize other plans for this purpose, but it is unclear how this will be applied.

The ObamaCare law contains several exemptions. Two relevant ones are for individuals who do not maintain insurance for three months or less during the taxable year and qualified expatriates.

United States persons who are resident abroad and are "qualified individuals" for purposes of the foreign earned income exclusion of section 911 of the Code are deemed to have "minimum essential coverage" and are, therefore, not subject to the penalty tax. A "qualified individual" is a citizen of the United States who establishes that he is a bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year or who, during any period of twelve consecutive months, is present in a foreign country or countries during at least 330 full days in such period. It is possible for a person to live outside the United States and fail the "qualified individual" test for the foreign earned income exclusion. In those cases, a person could be subject to the penalty tax.

In summary, United States persons resident abroad who qualify for the foreign earned income exclusion should not be subject to the ObamaCare penalty. However, it is possible that the penalty may be imposed in other cases. It is unclear whether foreign jurisdictions that generally grant a foreign tax credit for US income taxes would grant a credit for the so called "shared responsibility" payment.

Hospital Insurance Tax

ObamaCare imposes a 0.9 percent "hospital insurance" tax (the Hospital Insurance Tax) on individuals with incomes exceeding $200,000 or $250,000 for joint filers. This tax is assessed as part of the Federal Insurance Contributions Act (FICA). However, unlike standard FICA contributions, there is no corresponding employer tax. The tax is also assessed under the Self-Employment Contributions Act (SECA), which is the equivalent provision for self-employed persons, including partners in partnerships.

The Hospital Insurance Tax only applies to earnings subject to FICA/SECA. As a result, expatriates who are exempt from FICA/SECA due to a "certificate of coverage" under their home country's Social Security tax treaty with the United States may be exempt from this tax as well. We expect guidance at some point from the Service confirming this conclusion. If a person either does not have a certificate of coverage or if they are resident in a country without a social security treaty with the United States, and their gross income exceeds the minimum thresholds discussed above, they could be subject to this additional tax.

This provision is effective for taxable years beginning after December 31, 2012.

Medicare Tax on Investment Income

ObamaCare also subjects investment income to an additional 3.8 percent tax (the Medicare Tax). The Medicare Tax is not deductible for US federal income tax purposes.

Investment income includes gross income from interest, dividends, annuities, royalties, and rents, other than such income derived in the ordinary course of a trade or business that is neither a passive activity nor a trade or business of trading in financial instruments or commodities. Other gross income derived from a trade or business that is a passive activity with respect to the taxpayer is also included. Gains from the disposition of property (other than inventory or property held in a trade or business) are also included in the definition. Look-through rules apply to gain from the disposition of a partnership interest or S corporation shares. Investment income is reduced by deductions properly allocable to such income.

The investment income definition does not include some investment related income, such as income from derivatives. It is unclear what types of non-covered income will be covered by regulations or similar guidance.

The Medicare Tax is 3.8 percent of the lesser of (1) an individual's net investment income or (2) the excess of the individual's modified adjusted gross income (AGI) over the applicable threshold amount. For this purpose, modified AGI is the individual's AGI increased by the amount excluded from income as foreign earned income, net of deductions and exclusions disallowed with respect to the foreign earned income. The applicable threshold amount is $250,000 for joint filers, $125,000 for married individuals filing separately, and $200,000 for individuals.

The Medicare Tax is specifically drafted to cover most income from investment partnerships. There is an "active trade or business" exclusion, but it does not cover income from either an activity deemed "passive" with respect to the taxpayer or from a trade or business of trading in financial instruments or commodities. Thus, income from a typical private equity, venture capital, real estate or hedge fund formed as a partnership for US federal tax purposes should be caught by these provisions.

The Medicare Tax will not apply to income that is taxed as self-employment income under the SECA provisions. This exclusion will not be available to expatriates if the income is not actually taxed as self-employment income in the United States. Taxation under another country's similar provisions appears not to qualify given the statutory language used.

The Medicare Tax is unlikely to benefit from the same treaty-based exclusion available for the Hospital Insurance Tax. Although the Service has not issued any guidance on this point, it seems unlikely that this tax would be exempted by a Social Security tax treaty for expatriates benefitting from a certificate of coverage in their home country.

This provision is effective for taxable years beginning after December 31, 2012.

Net Impact on Investment Fund Partners

Expatriate partners in a typical investment fund should expect to pay the additional Medicare Tax on their share of the fund's investment income, as well as on any other investment or passive income the expatriate partner may derive from personal assets. Thus, if the "Bush tax cuts" were extended across the board, a private equity partner eligible for a 15 percent tax rate on long-term capital gains and qualified dividend income derived from a carried interest should see the effective tax rate rise to 18.8 percent. Similarly, under that circumstance, income not eligible for the 15 percent rate should rise from 35 percent to 38.8 percent.

If, on the other hand, the "Bush tax cuts" expire at the end of 2012 as they currently are scheduled to do, the top tax rates would increase. The top tax rate for ordinary income would go from the current 35 percent to 39.6 percent. Dividends would be taxed as ordinary income. Capital gains would be taxed at a top rate of 20 percent. Thus, for investment income the top tax rate would rise to 43.4 percent for ordinary income, short-term gains, and dividends. The top tax rate for capital gains would rise to 23.8 percent.

The other provisions should not create material issues for genuine expatriates. Qualifying expatriates should not be subject to the individual mandate penalty. However, if they fail to qualify for the earned income exclusion in any particular year they may face the penalty. The Hospital Insurance Tax should not apply if the expatriate has a certificate of coverage under a social security treaty between their home country and the United States. If that is not available then an additional 0.9 percent tax should apply to their gross income in excess of the threshold amount.

* * *

Circular 230 Notice: To ensure compliance with requirements imposed by the Service, we inform you that any U.S. tax advice contained in this communication is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

Celebrating more than 125 years of service, King & Spalding is an international law firm that represents a broad array of clients, including half of the Fortune Global 100, with 800 lawyers in 17 offices in the United States, Europe, the Middle East and Asia. The firm has handled matters in over 160 countries on six continents and is consistently recognized for the results it obtains, uncompromising commitment to quality and dedication to understanding the business and culture of its clients. More information is available at www.kslaw.com.

This alert provides a general summary of recent legal developments. It is not intended to be and should not be relied upon as legal advice.