Mahoney & Associates

On Point POSITION PAPER

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Health Care Reform Tax Changes: Who Wins and Who Pays?

The 'Patient Protection and Affordable Care Act' (a/k/a "Health Care Reform") became law on March 23, 2010, with certain "fixes" contained in the 'Health Care and Education Reconciliation Act of 2010' being signed into law one week later on March 30, 2010. This **On Point Position Paper** will take a look at how it will affect the federal tax picture.

The Tax Changes

The combined legislation contains numerous tax provisions. The following is a timetable and brief description of the key changes:

2010:

- Small employers (25 employees or less; average annual employee compensation of $50K or less) are given a tax credit for the purchase of health insurance for employees. The amount of the credit could be as high as 35% of what the employer contribution was before 2014, and as much as 50% of what the contribution was for later years, depending on specific circumstances.
- A 10% "UV" tax is imposed on indoor tanning services.
- Adoption tax incentives are increased by $1,000 for 2 years and credits are made refundable.
- Annual taxes/fees are imposed over ten years on brand-name pharmaceutical companies and health insurance providers totaling $27 billion and $60 billion respectively and are allocated according to market share.
- Penalties for non-qualified HSA and Archer Medical Savings Account (MSA) distributions are doubled to 20%.

2013:

- A $2,500 annual cap is imposed on annual *health* FSA contributions.
- The Medicare Tax increases by 0.9% on earnings over $200,000 for individuals and over $250,000 for joint filers.
- The threshold for deduction of personal medical expenses is increased from 7.5% to 10%.
- The Employer deduction for *retiree* prescription drug subsidies is eliminated. (Note: This has already resulted in a large and highly-publicized charge to 2010 earnings for several major companies.)
- A 2.3% excise tax is implemented on medical devices.

- A $500,000 tax deduction cap is placed on compensation paid to insurance company employees and officers.

2014:

- Individuals without government-approved coverage become subject to an annual tax of the greater of $695 or 2.5% of income. The dollar amount is phased in at $95 for 2014 and $325 for 2015 going to the full amount in 2016. The percentage limit is phased in at 1% for 2014, 2% for 2015 and going to the full percentage in 2016. After 2016 the dollar amount is indexed for inflation. The tax is further capped by the national average "bronze plan" premium.
- Employers with 50 or more employees who do not offer coverage to their employees will be assessed an annual penalty of $2,000 for each full-time employee in excess of the first 30, provided at least one employee receives a subsidy or a tax credit.
- Employers offering coverage but which have at least one employee receiving a subsidy or tax credit will be assessed a fee of $3,000 for each such worker, but not to exceed its number of full-time employees multiplied by $2,000.
- Individual tax credits become available for exchange-based coverage with amounts varying by income up to 400% of poverty level.

2018:

- The Cadillac tax is imposed on "high cost plans". The tax on insurance companies will be 40% of the annual benefit value above $10,200 for individual coverage and $27,500 for family or self-only collectively bargained multiemployer plan coverage.

What the Changes May Mean to the Taxpayer

Other than the small business tax credit, the individual tax credit for exchange-based coverage and the 2-year adoption incentive, the legislation contains virtually no tax breaks for individuals or businesses. On the other hand, the package contains many new taxes and tax increases. Therefore, health care reform seems likely to bring a significantly increased tax burden to individuals, businesses and the insurance industry. One can certainly expect businesses and the insurance industry to pass most, if not all of these new costs on to their customers and policyholders (to the extent the market will bear). Thus, it would seem that absent a substantial offsetting decline in the cost of health care and health insurance or a decline in national income from another round of recession and price deflation, the legislation has the potential to increase the average American's cost of living. Without substantial growth in national income to offset these increased costs, consumer spending could be suppressed, threatening the well-being of industries of all kinds, not to mention job creation efforts.

Can reform really achieve a substantial decline in the per capita cost of health care to offset these new taxes and not harm the economy? It is hard to see how it can be achieved in the early years. As discussed in our recent ***e*ActionAlerts**, pre-existing condition exclusions and lifetime limits are going to be abolished for all plans in the not too distant future.
Also, eligibility for dependent coverage will be expanded for those plans which offer dependent coverage. These three changes will each, in their own way, drive costs up.
Of the three, the abolition of pre-existing conditions limitations may have the greatest potential for adverse financial impact.

No Pre-ex and the Individual Mandate

The 2014 elimination of the pre-existing condition exclusion is potentially very problematic. For all intents and purposes, when health care reform is fully implemented, you will be able to wait on the sidelines until you are sick and only *then* buy health insurance (provided you are willing to pay or at least risk paying the penalty tax). It is rather like purchasing homeowners insurance as smoke pours out of your bedroom window. How can this *not* drive up per person costs? The answer may all ride on the successful implementation of the controversial "Individual Mandate".

The Individual Mandate, which requires citizens to purchase health insurance or face a monetary fine, reflects one of the cornerstones of insurance – spread of risk. The Congress wanted to make sure the health care system was being financed by **all** eligible Americans, not just by those who thought they had the highest probability of getting sick. That is adverse selection at its worst. If the Individual Mandate is successfully implemented, it could lead to lower per person costs for health care and health insurance. In the absence of an Individual Mandate, however, health care reform becomes little more than guaranteed coverage for the sick or becoming sick, paid for by the rest of us… if, indeed, there are enough of "us" to carry the burden.

The Individual Mandate is already under constitutional siege in many courts around the country and will continue to be under attack for months or even years to come. If the mandate does not survive these challenges, health care reform will have all the characteristics of a runaway train, inevitably destined to spectacular destruction at the end of the track.

It is difficult if not impossible to quantify these considerations. How do you handicap the odds of the Individual Mandate surviving legal challenges? And even if it survives, what level of voluntary compliance will be achieved? Indeed, civil disobedience could bring down the whole new system regardless of the outcome in court. We are skeptical of all cost estimates we see. At this early stage there are simply too many wild cards in the deck to make credible predictions. Now that this is law, we can only hope for the best and try to make the new system work.

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