

May 10, 2010

Re: House Rule 3590--"Patient Protection and Affordable Care Act", as amended
House Rule 4872 -- "Health Care and Education Reconciliation Act of 2010"

Dear Client:

This letter will focus you on most of the revenue raising and other revenue-related provisions of the "Patient Protection and Affordability Care Act" ("Act One"), passed by the United States Senate on December 24, 2009 and the House of Representatives on March 21, 2010, and signed by President Obama March 23, 2010, and of the Health Care and Education Reconciliation Act of 2010 ("Act Two"), passed by both houses of Congress within a few days thereafter, and signed into law by President Obama on March 30, 2010. These two new laws (together the "Act") make material changes to the Internal Revenue Code of 1986, as amended (the "Code"), in terms of tax increases, tax information reporting and IRS enforcement. This letter does not address the spending and government control sides of the Acts.

Changes in the Nature of Individual Tax Increases

Act One §9015 adds new §§3101(b)(2) and 1401(b)(2) to the Code. With respect to wages or self-employment income received during any year beginning from and after January 1, 2013, individual taxpayers owe an additional tax equal to .9% (nine-tenths of one percent) thereof. However, this tax increase applies only to wages or self-employment income in excess of \$250,000, in the case of joint income tax returns (\$125,000 if married filing separately), and \$200,000 in any other case. The employer must withhold this new tax for those employees

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making over \$200,000. One affect of Act One §9015 is to increase the current employee portion of the hospital portion of Social Security from 1.45% to 2.35%. There is no adjustment for inflation. In the future, more families' wages and self-employed income will become subject to the tax as a result of bracket creep.

Act Two §1402 adds new §1411 to the Code concerning a “Medicare Contribution” tax. By way of background, for the first time since the Tax Reform Act of 1976’s then new and lower 50% maximum rate on income from personal services, compared to a 70% rate on “unearned income,” the Code will impose higher taxes on income conceived to be more easily got and denominated "unearned income". For years beginning from and after January 1, 2013, affected individuals or families will pay 3.8% of the lesser of annual (a) “net investment income” or (b) the excess of adjusted gross income (including for this purpose §911 foreign earned income) over a threshold amount. The threshold amount equals \$250,000 in the case of joint returns (\$125,000 if married filing separately) or a surviving spouse and \$200,000 in any other case. Estates or trusts will pay 3.8% of the lesser of annual (a) undistributed net investment income or (b) the excess of adjusted gross income over a threshold amount of \$7500. In a departure from the current income tax, there is no adjustment for inflation. In the future, more individuals, trusts and estates’ net investment incomes will become subject to the tax as a result of bracket creep.

The term "net investment income" is a complex and broad matter. I am certain the definition is not settled law. That said, the term includes an individual, trust or estate’s share of net income from the trade or business of trading in financial instruments or commodities (§475(e)(2) of the Code) and from any other trade or business, which, as to the individual, estate or trust in question, is a “passive activity” as defined in §469 of the Code. The term also includes the gross amount of taxable interest, dividends, annuities, royalties and rents received, less related, available deductions, except if the gross income item in question derives from a trade or business other than the two described in the preceding sentence. The term also includes taxable gains from the sale or other disposition of any property except if the property in question had been held for use in a trade or business other than the two kinds previously described. Concerning this last basis for imposing this new 3.8% tax, there are complex rules concerning

the extent of the imposition of the 3.8% tax on individuals, estates or trusts who will be selling ownership interests in limited liability companies, S corporations and partnerships after December 31, 2012.

The Act One §§9005 and 10902, as amended by Act Two §1403, amends §125 of the Code effective for taxable years beginning on or after January 1, 2013. Essentially, assuming an employer offers a "cafeteria plan" to employees that permits them to choose to put aside otherwise taxable income to pay for health care expenses, no more than \$2500 per year, indexed for inflation for tax years beginning January 1, 2014, may be set aside. This law reflects a policy choice of moving away from personal health coverage responsibility. §1515 of Act One provides for a "simplified cafeteria plan" that may be offered by employers of 100 or fewer employees. This initiative dovetails with the relatively low \$2500 per year limit.

Some individuals or families experience extraordinary, under or uninsured medical expenses during a given year. Prior to the Act, §213 of the Code allowed a deduction for unreimbursed medical expenses to the extent exceeding 7.5% of adjusted gross income for the year in question. §9013 of Act One increases the thresholds to 10% of adjusted gross income effective for taxable years beginning on or after January 1, 2013, with an exception if a taxpayer or the spouse of a taxpayer attains age 65 before the end of the excepted taxable years: 2013, 2014, 2015 and 2016. Accordingly, the 7.5% threshold remains available on a limited, phased-out basis for older taxpayers. This law reflects a policy choice of moving away from personal health coverage responsibility.

Changes in the Nature of Taxes on Business

Effective for years beginning on or after January 1, 2018, Act One §§9001 and 10901 adds new §4980I to the Code. §4980I imposes a non-income tax deductible, excise tax on insurance companies, and in case of certain types of employee health plans, employers, in respect of high cost health insurance. The tax is equal to 40% of "excess benefits". For 2018 "excess benefits" arise once the cost of coverage for an employee or former employee having self

only coverage exceeds a \$10,200 threshold or the cost of coverage for an employee or former employee and family members exceeds a \$27,500 threshold, in each situation increased by the "health cost adjustment percentage" and possibly also increased by an "age and gender adjusted excess premium amount". In addition, the threshold amount is indexed for inflation beginning 2019. The "health cost adjustment percentage" is designed to increase the thresholds if the actual growth in the costs of healthcare in the USA between 2010 and 2018 exceeds the administration's projected growth in costs for this period. This likely changing threshold amount is then increased for any additional premium cost, given the age and gender characteristics of the workforce in question compared to the cost of coverage priced for the age and gender characteristics of the national workforce as a whole. There is a further threshold increase for plans covering employees in favored occupations such as longshoremen, construction trades workers and cops and firemen. The benchmark coverage with reference to which the thresholds have been set is the present Blue Cross/Blue Shield standard benefit option under the Federal Employees Health Benefits Plan. Separate dental insurance plans and/or eyeglass and similar vision plans are excluded from the scope of new §4980I.

A complex tax reporting mechanism requires each employer to ascertain whether and to what extent its health insurance plan involves excess benefits. The employer (subject to IRS penalties) is required to report the excess benefit amounts to its insurance company or to the plan administrator in the case of employer self-insured plans, and the insurance company (or employer) in turn is responsible for paying the tax of 40% of the reported excess benefits. If an employer underreports the excess benefit amounts to its insurance company, the employer is subject to a tax penalty equal to the excise tax unpaid by the insurer, plus interest.

No doubt the new §4980I 40% excise tax will not be absorbed by insurance companies or employers. Accordingly, the de facto result will be a leveling of health insurance benefits across the population regardless of ability or willingness to pay for the same. Much remains to be seen whether this policy in practice will violate the laws of economics or whether §4980I will be upheld as constitutional.

Effective for years beginning on or after January 1, 2013, Act One §1513, as amended by Act Two §1003, adds new §4980H to the Code. Very simplified, new §4980H imposes on employers of more than 50 full-time employees two alternative taxes or assessable penalties (the Act uses both terms) under specified circumstances. A tax or assessable penalty of \$2,000 per full time employee per annum is imposed for each year such an employer does not offer “minimum essential coverage”, but the penalty is not computed with respect to the first 30 full-time employees. A tax or assessable penalty of \$3,000 is imposed per each full time employee per annum getting the Act’s new government subsidized health insurance notwithstanding the fact the employer offers “minimum essential coverage”. The imposition of this new \$3,000 “tax” is subject to a limit of what the tax would be assuming hypothetically the employer were subject to the \$2,000 “tax” for the year in question. After 2014, the tax is increased for annual inflation.

Effective for years beginning on or after January 1, 2013, Act One §§1501 and 10106, as amended by Act Two §1002, adds new §5000A to the Code. Very simplified, new §5000A imposes a penalty equal to the greater of (a) 2.5% of household income over the threshold amount required for income tax return filing (for 2010 \$9,350 for single person and \$18,700 for married filing jointly) or (b) \$695 per uninsured or underinsured adult residing in the household. An additional penalty applies for each member of the household under age 18: the penalty equals one-half of the adult penalty applicable to the household, or 1.25%. The total household penalty cannot exceed a capped sum. The penalty amounts are not fully phased in until 2016. For years 2014 and 2015, the penalties are as follows: 2014, the greater of \$95 per uninsured household adult or 1% of household income over the threshold; for 2015, \$325 or 2% of such income. Beginning with 2017, the penalty is increased for inflation. §5000A's penalty regime applies to "non-exempt" U.S. citizens and legal residents. The exemption categories are for persons incarcerated, not legally present in the United States or who are members of a recognized religious sect exempt from self-employment taxes under current law. Complex rules define what constitutes minimum health insurance coverage, and numerous other fine points, such as what if a family has health insurance for 9 months of a given calendar year but not for all 12 months. In this latter case, the penalty is not applied as long as health insurance is in place no

less than 9 months. From the unusual, enumerated statutory rationale set forth in the Act, one can conclude the authors of §5000A have postured for defense of a constitutional challenge.

Act One §9017 adds new §5000B to the Code, The essence is imposition of an "excise tax" equal to 10% of the amount a customer pays for indoor tanning services. The term "indoor tanning services" does not apply to what is referred to as "phototherapy services" performed by licensed medical professionals. Accordingly, it appears that ultraviolet treatments for psoriasis and similar conditions are exempted from the new 10% excise tax. Providers of indoor tanning services are required to collect the tax as part of the service charge and remit quarterly to the IRS, effective for services performed on or after July 1, 2010. This new 10% excise tax is reminiscent of the 1991 imposition of 10% excise taxes on luxury items, such as "yachts", and on expensive automobiles, jewelry and furs, which taxes devastated the U.S. small boat building industry, and were all subsequently repealed by Congress.

Changes in the Nature of Tax Incentives

Act One §1421 and §10105 adds §45R to the Code. Boiled down past complexities, an employer employing less than 25 full time employees and who averages no more than \$50,000 in annual wages may claim a tax credit for up to 50% of its employer's cost of providing health insurance coverage, and, as allowed by pre-Act law, take a deduction for the cost of employee healthcare coverage; now however, minus the dollar amount of any new §45R credit. Only employers having less than 11 employees and an average payroll less than \$25,000 will be eligible for the full credit. The credit expires after 2015, indicating a policy decision that it will become unnecessary or undesirable in light of anticipated changes in the law and/or insurance market as a result of the Federal government's increased power over the medical care industry. For years 2010 through 2013, the credit can be claimed with respect to the cost of health insurance coverage purchased from any insurance company licensed under any state law. For years 2014 and 2015, the credit is available only for health insurance coverage purchased through a state or group of states' "insurance exchange" (the new rate regulated insurance market provided for under the Act). The credit is a general business credit, and accordingly, if the credit

available to a qualifying small employer exceeds its income tax for a given year it may be carried back one year and then carried forward as far as 20 years.

Act One §9023 adds §48D to the Code. Boiled down past complexities, §48D sets aside \$1B presumably of the Federal budget on a retroactive basis beginning January 1, 2009 and ending December 31, 2010. The \$1B is available to taxpayers investing in "qualifying therapeutic discovery projects" undertaken by employers of not more than 250 employees, if a given project applies for and is awarded a certification by the applicable Federal government agency. Only for-profit small employers are eligible to apply for the credits. Interestingly, grants in lieu of the credit of up to \$500M may be awarded instead of the credit itself. This is an unusual Code provision modeled after last year's new §48C of the Code. Section §48C set aside \$2.3B of the 2009 "stimulus" spending bill's billions for application/government agency award tax credits for qualifying "advanced energy projects".

Act Two §1004 amends §162(l) of the Code, which provides for a deduction for healthcare insurance for self-employed individuals, to claim the deduction for premium costs for children not yet age 27 at the end of the year. In this connection, in many other aspects, the Act requires or allows family insurance coverage to cover children not yet 27 at the end of the year.

Changes Increasing Information Reporting to the IRS

Act One §9002 requires every employer to set forth on an employee's annual Form W-2 the dollar value of the employee's health insurance coverage paid for by the employer. This new reporting requirement is effective for years beginning on or after January 1, 2011.

Act One §1502 adds new §6055 to the Code effective for years beginning from and after January 1, 2013. This new provision requires all providers of health insurance (unless exempted) to report the presence or absence of qualified health insurance coverage to the individual or family in question and to the IRS. In effect, this provision adds to the 1099 family of information reporting returns, with the usual IRS penalties for non-compliance.

Act One §1514 adds new §6056 of the Code. This new provision requires employers subject to the Act One §1513 §4980H tax to report specific information to the IRS and employees concerning its §4980H compliance or lack thereof, with the usual IRS penalties for non-compliance.

Changes Increasing Taxes on Targeted Industries

The Act provides for special taxes on the following industries: medical devices manufacturers and importers; health insurers; branded prescription pharmaceutical manufacturers and importers.

Act Two §1405 imposes an annual excise tax on the medical device manufacturers and importers. This excise tax, new §4191 of the Code, is imposed annually at an amount equal to 2.3% of a covered entity's gross receipts from medical device sales. The excise tax will be imposed for 2013 and subsequent years. The payment date is not established; however, it is indicated to be no later than September 30 of the year for which the tax is due and payable. "Medical devices" mean any device as defined in §201(h) of the Federal Food, Drug and Cosmetic Act intended for humans. The definition is of considerable breadth. Generally, only medical devices primarily sold to consumers at retail are excluded from gross receipts. Also excluded are eyeglasses, contact lenses and hearing aids.

Act One §9010, as modified by §10905, and amended by Act Two §1406 imposes an annual fee on all entities engaged in the business of providing health insurance, except those expressly excluded from the imposition of the tax. As in the case of the excise tax on medical device manufacturers and importers, the new fee is imposed with respect to sales, in this case, ". . . net premiums with respect to health insurance for any United States health risk . . . ". The formula for imposition of the tax is very complex and can be summarized as follows: the net premiums of all covered entities for a calendar year are aggregated, based presumably on the basis of mandated reports to the IRS, and the covered entities pay a portion of the excise tax in

the proportion that their respective net premiums bear to all of the aggregated net premiums. Only 50% of the net premiums of specified tax-exempt insurance providers are taken into account in calculating their respective portions of the excise tax. The proportions thus determined are of a dollar amount of total excise tax for each year, to wit: \$8B for 2014, 2015 and 2016, \$10B for 2017 and \$14.3B and for 2019 and thereafter the tax base will increase in a proportion to the rate of industry net premium growth.

Health insurers excluded from the new excise tax are in the nature of government funded companies; also excluded are private sector insurers receiving net premiums of less than \$25M per year. The new excise tax is effective for 2014 and later years.

§9008 of Act One, as amended by §14040 of Act Two, imposes an annual fee on branded prescription drugs sales of all entities engaged in the business of manufacturing or importing branded prescription drugs. The fee does not apply to all sales of branded prescription drugs, but to most sales of such drugs, ". . . to any specified government program or pursuant to coverage under any such program." The government programs in question are Medicare Part D, Medicare Part B, the Medicaid program, prescription drugs procured by the Department of Veterans Affairs, procured by the Department of Defense or sold under the TRICARE retail pharmacy program under §1074g of Title 10, United States Code. This fee is imposed beginning 2011.

The formula for imposition of the fee is complex and can be summarized as follows: each covered entity pays a portion of the annual aggregate fee in the proportion that its covered sales of brand name prescription drugs over graduated thresholds bears to all sales of brand name prescription drugs by covered entities. The dollar amount of the fee for each year is as follows: \$2.5B in 2011, \$2.8B in each of 2012 and 2013, \$3B in each of 2014, 2015, and 2016, \$4B in 2017, \$4.1B in 2018 and \$2.8B in 2019 and years thereafter.

§9014 of the Act prohibits a health insurance provider from deducting compensation in excess of \$500,000 paid to any officers, directors, consultants or other employees, regardless of whether or not such compensation would otherwise qualify as performance based compensation

as defined in §162(M)(4) of the Code. This targeted denial of the business expense deduction for compensation in excess of \$500,000 is effective for tax years beginning on or after January 1, 2010.

Conclusions

I trust you have found this summary educational. There is much, much more to the Acts beyond these selected revenue related provisions. Our attorneys working in the taxation and employee benefits areas are preparing to advise you further as your needs may arise.

Very truly yours,

LINDABURY, McCORMICK, ESTABROOK & COOPER

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