Review of Selected Tax Provisions Included in Health Care Legislation

Introduction

The Patient Protection and Affordable Care Act, signed into law by the president on March 23, 2010 (the "Health Care Act"), and the Health Care and Education Reconciliation Act of 2010, signed into law by the president on March 30, 2010 (the "Reconciliation Act," and together with the Health Care Act, the "Legislation") effect a massive overhaul of the U.S. health care system. Although the centerpiece of this health reform Legislation is the mandate for most U.S. residents to obtain health insurance, the Legislation also carries various tax provisions, including provisions relating to (i) certain revisions to the Medicare tax and (ii) codification of the economic substance doctrine.

Certain Medicare Tax Revisions

The Federal Insurance Contributions Act ("FICA") imposes two taxes to finance Social Security and Medicare benefits. These two taxes, the Old Age, Survivors and Disability Insurance ("OASDI") tax and the Medicare Hospital Insurance ("HI") tax, are imposed on employers, with respect to wages paid, and on employees, with respect to wages received. The OASDI tax rate is 6.2% and is imposed on wages up to an annually-adjusted ceiling, which for 2010 is $106,800. The HI tax rate is 1.45% and is imposed on all wages with no ceiling.

Similar to FICA, the Self-Employment Contributions Act ("SECA") imposes OASDI and HI on a self-employed individual's net income from self-employment at rates of 12.4% and 2.9%, respectively. As with FICA, the annually-adjusted ceiling with respect to OASDI is $106,800 for 2010 (reduced by the wages that the individual receives during a tax year).

New 3.8% Medicare Contribution Tax on Certain Net Investment Income

Prior to the Legislation, there was no Medicare tax on unearned income. The Legislation imposes an unearned income Medicare contribution tax on individuals at 3.8% of the lesser of (i) an individual's net investment income or (ii) the excess of such individual's modified adjusted gross income ("MAGI") over a threshold amount, which is $250,000 for joint returns or surviving spouses, $125,000 for separate returns, and $200,000 in other cases. For trusts and estates, the tax is 3.8% of the lesser of (i) undistributed net investment income or (ii) the excess of adjusted gross income over the dollar amount at which the highest estate and trust income tax bracket begins, provided, however, that this tax does not apply to certain trusts. These provisions are applicable to tax years beginning after December 31, 2012.

Net investment income generally refers to the excess (if any) of (i) the sum of (a) gross income from interest, dividends, annuities, royalties and rents (unless such income is derived in the ordinary course of a trade or business to which the Medicare contribution tax does not apply), (b) other gross income derived from a trade or business to which the Medicare contribution tax applies and (c) net gain attributable to the disposition of property (other than property held in a trade or business to which the Medicare contribution tax does not apply), over (ii) the allowable deductions properly allocable to such gross income or net gain.

The Medicare contribution tax applies to a trade or business if it is a passive activity of the taxpayer (within the meaning of Section 469 of the Code) or a trade or business of trading in financial instruments or commodities (within the meaning of Section 475(e)(2) of the Code). Generally, for purposes of determining this tax, MAGI is a taxpayer's adjusted gross income increased by the amount excluded from income as foreign earned income, net of the deductions and exclusions disallowed with respect to such foreign earned income.

It should be noted that the Medicare contribution tax is treated as a "tax" for purposes of computing a taxpayer's penalty for the underpayment of estimated tax.

Additional 0.9% Medicare Tax

The Legislation provides that for tax years beginning after December 31, 2012, an additional 0.9% HI tax will be imposed under FICA on an individual taxpayer's wages received with respect to employment in excess of (i) $250,000 for joint returns, (ii) $125,000 for married taxpayers filing a separate return, and (iii) $200,000 in all other cases. Therefore, for tax years beginning after the effective date, the HI tax rate will be (i) 1.45% with respect to the first $200,000 of wages ($250,000 of combined wages for joint returns and (ii) 2.35% (*i.e.*, 1.45% + 0.9%) with respect to wages in excess of $200,000 ($250,000 of combined wages on a joint return). The Legislation does not affect the HI tax imposed on employers.

Similarly, under SECA, the Legislation provides that for tax years beginning after December 31, 2012, an additional 0.9% HI tax will be imposed on an individual taxpayer's self-employment income for the tax year in excess of (i) $250,000 for joint returns, (ii) $125,000 for married taxpayers filing a separate return, and (iii) $200,000 in all other cases. Therefore, for tax years beginning after the effective date, the HI tax rate will be (i) 2.9% with respect to the first $200,000 of self-employment income ($250,000 of combined self-employment income for joint returns and (ii) 3.8% (i.e., 2.9% + 0.9%) with respect to self-employment income in excess of $200,000 ($250,000 of combined self-employment income on a joint return). If a taxpayer who is subject to the SECA tax is also subject to the FICA tax (*i.e.*, such taxpayer has both net earnings from self-employment and wages received from an employer), the above thresholds will be reduced by the amount of wages taken into account in determining the additional 0.9% HI tax under FICA.

Codification of Economic Substance

Under common law, courts have applied an "economic substance" doctrine to deprive tax benefits to a taxpayer who engages in a transaction that does not result in any meaningful change in the taxpayer's economic position, other than the reduction in the taxpayer's U.S. federal income tax liability. The same concept has been expressed by the terms "business purpose" and "substance over form," among others. Courts have applied these tests in a non-uniform manner. Some courts have held that the tax benefits will be disallowed unless the transaction has both economic substance and a legitimate business purpose. Other courts allow the tax benefits if the transaction has either a legitimate business purpose or economic substance.

The Legislation imposes the requirements of both prongs by providing that a transaction will be deemed to have economic substance (and, therefore, be respected for tax purposes) only if both of the following requirements are satisfied: (i) the transaction changes the taxpayer's position in a meaningful way (apart from the U.S. federal income tax effects) and (ii) the taxpayer has a substantial purpose (apart from the U.S. federal income tax effects) for entering into the transaction. Whether the economic substance doctrine is relevant to a transaction will be determined as if the Legislation did not exist. In general, the new provisions apply to transactions entered into after the date of enactment. They apply to transactions entered into by individuals only in connection with a trade or business or for the production of income.

For purposes of determining if the new tests have been met, the potential for profit is to be taken into account only if the present value of the reasonably expected pretax profit from the transaction is "substantial" in relation to the present value of the expected net tax benefit. To determine pretax profit, fees and other transaction costs are taken into account.

A financial accounting benefit will not be considered a substantial non-tax purpose for the transaction if the origin of that accounting benefit is a reduction of U.S. federal tax. Moreover, any state or local tax effect that is related to a U.S. federal income tax effect will be treated the same as a U.S. federal tax effect. Thus, if a transaction is undertaken for the purpose of generating state or local tax benefits, it may also be disregarded. Under the law in effect prior to the enactment of the Legislation, a transaction that generated significant state or local tax benefits, but little U.S. federal tax benefit and little profit, could have been upheld.

Failure to satisfy the economic substance test will be added to the list of events that can result in a penalty for underpayment of tax under Section 6662 of the Code. The penalty is equal to 20% of the amount of disallowance of tax benefits as a result of a transaction's lacking economic substance. Moreover, the penalty will increase from 20% to 40% in the case of an underpayment due to a transaction not disclosed in a tax return that lacks economic substance. The "reasonable cause exception" does not apply to avoid these penalties. Finally, the penalties also apply to transactions deemed to lack a "business purpose," under the related common-law doctrines, which are not superseded by this Legislation.

According to a report prepared by Congress' Joint Committee on Taxation, the new provisions are not intended to apply to certain "basic business transactions" such as (i) the choice of whether to capitalize a business with debt or equity, (ii) the choice by a U.S. taxpayer of whether to use a non-U.S. corporation or U.S. corporation to make a foreign investment, (iii) the choice to enter into a transaction or transactions that constitute a corporate organization or reorganization under Subchapter C of the Code, and (iv) the choice to use a related-party entity in a transaction, provided that the arm's-length standard and other applicable concepts are satisfied. Furthermore, the test would not be applied to transactions with targeted tax credits, for example, low-income housing and energy tax credits. Leasing transactions, on the other hand, will continue to be analyzed in light of all facts and circumstances.

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