Get ready for tax increases in 2013 under Affordable Care Act-July 22, 2012

Even if Congress were to somehow solve its tax extender problems and kick all the EGTRAA and JGTRRA sunsets down the road for another year, the fact remains that under the Affordable Care Act (the Patient Protection and Affordable Care Act, P.L. 111-148, and the Health Care and Education Reconciliation Act of 2010, P.L. 111-152), a number of important tax increases will go into effect next year. These include higher HI taxes for high earners, a 3.8% surtax on unearned income of higher-income individuals, and caps on health FSA contributions. These changes will cause compliance issues for companies, and some of them also will face new deduction limitations and fees. This article highlights the changes that loom for 2013, along with the scant guidance IRS has issued to date.

Increased HI tax for high-earning workers and self-employed taxpayers. For tax years beginning after Dec. 31, 2012, an additional 0.9% hospital insurance (HI) tax applies under Code Sec. 3101(b)(2) to wages received with respect to employment in excess of: $250,000 for joint returns; $125,000 for married taxpayers filing a separate return; and $200,000 in all other cases. Under Code Sec. 1401(b)(2), the additional 0.9% HI tax also applies to self-employment income for the tax year in excess of the above figures. (Code Sec. 6051(a)(14))

IRS guidance to date has consisted of a series of frequently asked questions (FAQs); see Weekly Alert ¶ 22 06/28/2012.

Surtax on unearned income of higher-income individuals. For tax years beginning after Dec. 31, 2012, an unearned income Medicare contribution tax is imposed on individuals, estates, and trusts. (Code Sec. 1411) For an individual, the tax is 3.8% of the lesser of either (1) net investment income or (2) the excess of modified adjusted gross income over the threshold amount ($250,000 for a joint return or surviving spouse, $125,000 for a married individual filing a separate return, and $200,000 for all others). For surtax purposes, gross income doesn't include excluded items, such as interest on tax-exempt bonds, veterans' benefits, and excluded gain from the sale of a principal residence.

To date, IRS hasn't issued any guidance on this surtax.

For planning articles dealing with the 3.8% surtax, see Weekly Alert ¶ 38 05/03/2012 and Weekly Alert ¶ 29 05/13/2012.

Higher threshold for deducting medical expenses. For tax years beginning after Dec. 31, 2012, unreimbursed medical expenses will be deductible by taxpayers under age 65 only to the extent they exceed 10% of adjusted gross income (AGI) for the tax year. (Code Sec. 213(a)) If the taxpayer or his or her spouse has reached age 65 before the close of the tax year, a 7.5% floor applies through 2016 and a 10% floor applies for tax years ending after Dec. 31, 2016. (Code Sec. 213(f))

Dollar cap on contributions to health FSAs. For tax years beginning after Dec. 31, 2012, for a health flexible spending account (FSA) to be a qualified benefit under a cafeteria plan, the maximum amount available for reimbursement of incurred medical expenses of an employee (and dependents and other eligible beneficiaries) under the health FSA for a plan year (or other 12-month coverage period) can't exceed $2,500. (Code Sec. 125(i))

Notice 2012-40, 2012-25 IRB 1046, provides guidance on the effective date of the $2,500 limit on salary reduction contributions to health FSAs under Code Sec. 125(i), and on when and how plans should be amended to comply with the limit. See Weekly Alert ¶ 13 06/07/2012.

Deduction eliminated for retiree drug coverage. Sponsors of qualified retiree prescription drug plans are eligible for subsidy payments from the Secretary of Health and Human Services (HHS) for a portion of each qualified covered retiree's gross covered prescription drug costs (“qualified retiree prescription drug plan subsidy”). These qualified retiree prescription drug plan subsidies are excludable from the taxpayer's (plan sponsor's) gross income for regular income tax and alternative minimum tax (AMT) purposes. For tax years beginning before 2013, a taxpayer may claim a business deduction for covered retiree prescription drug expenses, even though it excludes qualified retiree prescription drug plan subsidies allocable to those expenses. But for tax years beginning after Dec. 31, 2012, under Code Sec. 139A, the amount otherwise allowable as a deduction for retiree prescription drug expenses will be reduced by the amount of the excludable subsidy payments received.

IRS hasn't issued any guidance on Code Sec. 139A, which some analysts predict will prompt some employers to discontinue retiree drug coverage.

Fee on health plans. For each policy year ending after Sept. 30, 2012, each specified health insurance policy and each applicable self-insured health plan will have to pay a fee equal to the product of $2 ($1 for policy years ending during 2013) multiplied by the average number of lives covered under the policy. The issuer of the health insurance policy or the self-insured health plan sponsor is liable for and must pay the fee. (Code Sec. 4375, Code Sec. 4376, and Code Sec. 4377)

IRS has issued proposed reliance regs on this new fee; see Weekly Alert ¶ 7 04/19/2012 for details.

$500,000 compensation deduction limit for health insurance issuers. For tax years beginning after Dec. 31, 2012, for services performed during that year, a covered health insurance provider isn't allowed a compensation deduction for an “applicable individual” (officers, employees, directors, and other workers or service providers such as consultants) in excess of $500,000. (Code Sec. 162(m)(6)(A))

The are no exceptions for performance-based compensation, commissions, or remuneration under existing binding contracts. Also, in the case of remuneration that relates to services that an applicable individual performs during a tax year but that is not deductible until a later year, such as nonqualified deferred compensation, the unused portion (if any) of the $500,000 limit for the year is carried forward until the year in which the compensation is otherwise deductible, and the remaining unused limit is then applied to the compensation.

IRS has yet to issue guidance on this $500,000 limit on compensation deductions.

Excise tax on medical device manufacturers. For sales after Dec. 31, 2012, a 2.3% excise tax applies under Code Sec. 4191 to sales of taxable medical devices intended for humans. The excise tax, paid by the manufacturer, producer, or importer of the device, won't apply to eyeglasses, contact lenses, hearing aids, and any other medical device determined by IRS to be of a type that is generally purchased by the general public at retail for individual use.