On March 25, Congress passed H.R. 4872, the Health Care and Education Reconciliation Act of 2010 (the “Reconciliation Act”), and on March 30 President Obama signed the Act into law. The Reconciliation Act was passed in conjunction with H.R. 3590, the Patient Protection and Affordable Care Act (the “Health Care Act”), earlier signed into law on March 23. For purposes of the discussion below, the Reconciliation Act and the Health Care Act will oftentimes be referred to collectively as the “2010 Health Care Reform Act.”

The 2010 Health Care Reform Act will result in the largest overhaul of the U.S. health care system in the history of our country, which will affect nearly all individual taxpayers, many employers, and many health care providers and insurers.

This discussion is intended to supply a brief overview of the federal tax ramifications of the 2010 Health Care Reform Act insofar as it impacts (1) individual taxpayers and (2) business taxpayers.

**TAX CHANGES AFFECTING INDIVIDUALS**

**Changes effective March 31, 2010**

1. Dependent Coverage in Employer Sponsored Health Plans

   - The 2010 Health Care Reform Act extends the general exclusion for tax-free reimbursements for medical care expenses under an employer-sponsored accident or health plan to any child of an employee who has not attained age 27 as of the end of the tax year.

   - Under present law, the cut-off age for a child was 19, if not a student, or age 24, if a student, but, in either case, only if the child was also a “dependent” of the taxpayer.

**Changes effective as of January 1, 2011**

2. Limit on Reimbursement by HSAs, MSAs, and FSAs for over-the-counter drugs

   - The 2010 Health Care Reform Act will prevent the costs for over-the-counter drugs not prescribed by a doctor from being reimbursed on a tax-free basis through a Health Savings Account (HSA) or Archer Medical Savings Account (MSA), or from even being reimbursed through a Flexible Spending Account (FSA).

**Changes effective as of January 1, 2013**

3. Increase tax penalties on non-qualified distributions from HSAs or MSAs

   - The 2010 Health Care Reform Act will increase the additional tax on distributions from an HSA or a MSA that are not used for qualified medical expenses to 20% (presently set at 10% for HSAs and 15% for MSAs) of the disbursed amount.

**4. Floor on medical expenses deduction on Schedule A raised from 7.5% of adjusted gross income (AGI) to 10% of AGI**

   - Under current law, taxpayers can take an itemized deduction on Schedule A for unreimbursed medical expenses for regular income tax purposes only to the extent that those expenses exceed 7.5% of the taxpayer’s AGI.

   - The 2010 Health Care Reform Act raises the floor for itemized medical expense deductions from 7.5% of AGI to 10%. The AGI floor for individuals age 65 and older (and their spouses) will, however, remain unchanged at 7.5% through 2016.
5. Higher Medicare taxes on high-income taxpayers. High-income taxpayers will soon be subject to two new taxes. The first is a tax increase on wages and the second is a new tax levy on investment income.

- Higher Medicare payroll tax on wages.
  - Under current law, the gross wages payable to an employee are subject to a 2.90% Medicare payroll tax. Employees and employers each pay one-half of the tax (1.45% of gross wages).
  - Under the provisions of the 2010 Health Care Reform Act, most taxpayers will continue to pay the 1.45% Medicare hospital insurance tax, but single people earning more than $200,000 and married couples earning more than $250,000 will be taxed at an additional 0.9% (2.35% in total) on the excess over those base amounts.
  - Employers will collect and remit the extra 0.9% on wages exceeding $200,000 just as they would otherwise withhold Medicare taxes and remit them to the IRS.
  - Self-employed persons will pay 3.80% (2.90% + 0.90%) on earnings over the threshold.

- Medicare payroll tax extended to investment income.
  - Under current law, the Medicare payroll tax only applies to the taxpayer's wages.
  - Beginning in 2013, a Medicare tax will, for the first time, be applied to the taxpayer's investment income.
  - A new 3.80% tax will be imposed on net investment income of single taxpayers with AGI above $200,000 and joint filers over $250,000 (unindexed), but only to the extent the taxpayer's AGI exceeds such threshold amounts.
  - For this purpose, net investment income is interest, dividends, royalties, rents, gross income from a trade or business involving passive activities, and net gain from disposition of property (other than property held in a trade or business).

6. Limit of $2,500 on maximum amount that can be contributed to health FSAs

- An FSA is one of a number of tax-advantaged financial accounts that can be set up through a cafeteria plan of an employer.
- An FSA allows an employee to set aside a portion of his or her earnings to pay for qualified expenses as established in the cafeteria plan, most commonly for medical expenses but often for dependent care or other expenses.

- Under current law, there is no limit on the amount of contributions that taxpayers can make to their FSA.
- Under the 2010 Health Care Reform Act, allowable contributions to health FSAs will, however, be capped at $2,500 per year. The dollar amount will be indexed for inflation after 2013.

7. Excise Tax on Uninsured Individuals

- The 2010 Health Care Reform Act contains an "individual mandate"—a requirement that "most" U.S. citizens and legal residents must be covered by either an individually purchased health insurance policy or by an employer-sponsored health insurance plan.
- If not covered by any such policy/plan, the individual will be subject to a monetary penalty.
- Under the 2010 Health Care Reform Act, those individuals without qualifying health insurance coverage will pay a monetary penalty equal to the greater of: (a) $695 per year, up to a maximum of three times that amount ($2,085) per family, or (b) 2.5% of household income over the threshold amount of income required for income tax return filing.
- This tax penalty will actually be phased in according to the following schedule:

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<tbody>
<tr>
<td>Flat Fee</td>
<td>$95</td>
<td>$325</td>
<td>$695</td>
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<tr>
<td>% of Income</td>
<td>1.0%</td>
<td>2.0%</td>
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- Exemptions from the requirement that an individual have health care coverage will be granted for financial hardship, religious objections, those who are American Indians, those without coverage for less than three months, aliens not lawfully present in the U.S., incarcerated individuals, those for whom the lowest cost plan option exceeds 8% of household income, those with incomes below the tax filing threshold (in 2010 the threshold for taxpayers under age 65 is $9,350 for singles and $18,700 for couples), and those residing outside of the U.S.

8. Premium assistance tax credits for individuals purchasing health insurance

- One of the centerpieces of the 2010 Health Care Reform Act is its provision of tax credits to low and middle income individuals and families for the purchase of health insurance.
- For tax years ending after 2013, the new law creates a refundable tax credit (the "premium assistance credit").
for eligible individuals and families who purchase health insurance through a state health benefit exchange ("Exchange") (which each state is required to establish).

- The premium assistance credit, which is payable in advance directly to the insurer, subsidizes the purchase of certain health insurance plans through an Exchange.

- The premium assistance credit will be available for individuals and families with incomes up to 400% of the federal poverty level ($43,320 for an individual or $88,200 for a family of four, using 2009 poverty level figures) that are not eligible for Medicaid, employer sponsored insurance, or other acceptable coverage.

- The credits will be available on a sliding scale basis. The amount of the credit rises from 2% of income for those at 100% of the federal poverty level for the family size involved to 9.5% of income for those at 400% of the federal poverty level for the family size involved.

### TAX CHANGES AFFECTING BUSINESSES

#### Changes effective for Tax Years beginning after December 31, 2009

1. Tax credits to certain small employers that provide insurance

   - The 2010 Health Care Reform Act provides small employers with a tax credit for nonelective contributions by the employer which are used to purchase health insurance for their employees.

   - The credit can offset an employer’s regular tax or its alternative minimum tax (AMT) liability.

   - For the employer’s tax years beginning in 2010, 2011, 2012, or 2013, the amount of the tax credit is generally equal to 35% (50% for tax years beginning after 2013) of the employer’s nonelective contributions toward the employees’ health insurance premiums. The credit phases out as firm-size and average wages increase.

   - In lieu of a tax credit, tax-exempt small employers meeting these requirements are eligible for payroll tax credits of up to 25% for tax years beginning in 2010, 2011, 2012, or 2013 (35% in tax years beginning after 2013) of the employer’s nonelective contributions toward the employees’ health insurance premiums.

   - To qualify, a business must offer health insurance to its employees as part of their compensation and contribute at least half the total premium cost. The business must have no more than the equivalent of 25 full-time employees (FTEs), and the employees must have annual full-time equivalent wages that average no more than $50,000.

   - However, the full amount of the credit is available only to an employer with 10 or fewer FTEs and whose employees have average annual full-time equivalent wages from the employer of less than $25,000.

   - The credit is determined with respect to two phases:

     - **For the first phase**, the credit is initially available for any tax year beginning in 2010, 2011, 2012, or 2013. Qualifying health insurance for claiming the credit for this first phase of the credit is health insurance coverage purchased from an insurance company licensed under state law.

     - **The second phase** is for tax years beginning after 2013. For those years the credit is only available to an eligible small employer that purchases health insurance coverage for its employees through a state Exchange and is only available for two years.

#### Changes effective for Tax Years beginning after December 31, 2010

2. Small employers can establish a "simple cafeteria plan"

   - The 2010 Health Care Reform Act enables an “eligible employer” to create a “simple cafeteria plan” which is not required to meet the strict non-discrimination requirements that the Internal Revenue Code has imposed on pre-Act cafeteria plans.

   - By relaxing the need to satisfy such pre-Act non-discrimination requirements, an employer can now (to a limited degree) provide under a “simple cafeteria plan” more valuable welfare benefits to its Highly Compensated Employees than it offers to its Non-Highly Compensated Employees and as such, the more valuable benefits still retain their tax-free character.

#### Changes effective for Tax Years beginning after December 31, 2013

3. Certain large employers must contribute to their employees’ health insurance

   - For the first time ever, certain large employers (generally those employers who employ an average of at least 50 full-time employees during the preceding calendar year) which fail to offer health insurance coverage for all of their full-time employees, are potentially subjected to a monetary penalty.

   - The penalty is assessed whenever the large employer has at least one of its full-time employees who is certified as having enrolled in health insurance coverage purchased through a state Exchange with respect to which a premium tax credit or cost-sharing reduction is allowed or paid to the employee.
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4. The penalty for any month is an excise tax equal to the number of full-time employees over a 30-employee threshold during the applicable month (regardless of how many employees are receiving a premium tax credit or cost-sharing reduction) multiplied by one-twelfth of $2,000.

For example, if an employer fails to offer minimum essential coverage and has 60 full-time employees, ten of whom receive a tax credit for the year (i.e., for 12 months) for enrolling in a state Exchange-offered health insurance plan, the employer will owe $2,000 for each employee over the 30-employee threshold, for a total penalty of $60,000 ($2,000 multiplied by 30 (60 minus 30)].

This penalty is assessed on a monthly basis.

4. Certain large employers that actually offer coverage may still incur a penalty

The monetary penalty is an excise tax that is imposed on those large employers which have one or more employees who choose not to participate in the employer’s health insurance plan and instead receive a premium tax credit or cost-sharing reduction from the IRS for health insurance purchased through a state Exchange.

For each full-time employee receiving a premium tax credit or cost-sharing subsidy through a state Exchange for any month, the employer is required to pay for each such month an amount equal to one-twelfth of $3,000.

The penalty for each employer for any month is capped at an amount equal to the number of full-time employees during the month (regardless of how many employees are receiving a premium tax credit or cost-sharing reduction) in excess of 30, multiplied by one-twelfth of $2,000.

5. The “Cadillac tax” on high-cost health plans

The 2010 Health Care Reform Act places an excise tax on high-cost employer-sponsored health coverage (often referred to as “Cadillac” health plans).

This is a 40% excise tax on insurance companies, based on premiums that exceed certain amounts.

The tax is not on employers themselves unless they are self-funded.

However, it is expected that employers and workers will ultimately bear this tax in the form of higher premiums passed on by insurers.

For more information on how the 2010 Health Care Reform Act could impact you and/or your business, please contact your UHY Advisors’ tax professional.