

# The Income Tax Effects of Health Care Reform on Small Businesses and Real Estate Investors

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## INTRODUCTION

IF REAL ESTATE INVESTORS AND SMALL BUSINESS OWNERS intend to maximize after-tax profits and maintain appropriate levels of capital investment, they must have a working knowledge of the latest legislative changes enacted by the United States Congress that pertain to real estate and to small businesses. On March 23, 2010, President Barack Obama signed into law the Patient Protection and Affordable Care Act, followed closely (March 30, 2010) by the Health Care and Education Reconciliation Act which amended the Affordable Care Act (hereafter collectively called the Act). These major pieces of legislation contain (in addition to many non-tax items) several new or modified tax provisions and amendments to the Internal Revenue Code. Several of the provisions of these new laws have implications for real estate investors and/or real estate transactions, as well as small businesses

The purpose of this article is to summarize the provisions of several of the important changes to the Internal Revenue Code that are now the law or that soon will become the law and that pertain to real estate transactions and small businesses. Investors and small business owners are urged to look closely at this new legislation to seek ways in which they can significantly diminish their future income taxes. The following discussions focus on the major provisions of the new bills which, directly or indirectly, affect real estate transactions and small businesses. Some suggestions for tax planning are also included in the discussions. To determine the particular effect, if any, each of these provisions will have on a particular investment, each investor should consult with a qualified CPA, tax attorney or other tax professional.

## PENALTY ON EMPLOYERS THAT DON'T PROVIDE HEALTH CARE INSURANCE

Beginning in 2014, for employers with 50 or more full-time employees, the Act imposes a penalty on employers that don't offer coverage or offer coverage that pays less than 60 percent of health-related expenses. In determining whether a firm has 50 or more full-time employees, persons who work 30 or more hours per week are counted as full-time. In addition, the hours of part-time employees (for a month) are aggregated and divided by 120 to determine full-time equivalent employees. This computation is solely for purposes of assessing the penalty.

If an employer with 50 or more equivalent full-time employees fails to offer health insurance coverage to its full-time employees and their dependents, a penalty is imposed if at least one full-time employee is certified to the employer as having enrolled in health insurance coverage purchased through a state exchange for which a premium tax credit or cost-sharing reduction is allowed or paid to such employee. The penalty for having one



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employee enrolled in a subsidized program is \$167 per month for every full-time equivalent employee beyond 30. The maximum penalty per year is \$2,000 per full-time equivalent employee beyond 30. For example, if a firm employs 60 full-time equivalent employees and offers no health insurance coverage at all for the year, the penalty would be \$60,000 (60 employees minus the 30 employee threshold times \$2,000). Further, this penalty is not tax-deductible by the employer as an expense.

If an employer with 50 or more equivalent full-time employees offers health insurance coverage but the coverage offered pays less than 60 percent of health care costs, the employer is subject to a penalty if any full-time employee is certified to the employer as having enrolled in health insurance coverage purchased through a state exchange for which a premium tax credit or cost-sharing reduction is allowed or paid to such employee. In this case the penalty is not based on all employees, but it is imposed based on all employees who qualify for subsidized health insurance coverage and actually receive the credit or cost-sharing reduction mentioned above. The penalty is \$250 per month for each subsidized employee up to a maximum of \$3,000 per employee. The annual penalty is capped at the number of full-time employees above 30 times \$3,000. Again, the penalty is not deductible as an expense on the business tax return. Finally, the penalties discussed above are adjusted for inflation each year.

*Tax Planning Tips:* Since the above change is not effective until 2014, employers have some time to engage in tax reduction strategies. For example, the 50-employee number discussed above does not include seasonal workers. Therefore, a company that uses 49 workers most of the year but uses seasonal workers (those who work 120 or fewer days per year) will not be subject to the above penalties. Also, employers that are only at or above the threshold level by a few workers may consider reducing their workforce below 50 to avoid the penalties either by a reduction in force or by switching some of the work, when appropriate, from full-time workers to seasonal workers.

### EXCISE TAX ON HIGH-COST EMPLOYER PLANS

Section 4980I of the Internal Revenue Code of 1986 is amended to add this new excise tax. The excise tax applies when an employee is covered under any applicable employer-sponsored coverage at any time during the taxable year and there is any excess benefit with respect to

the coverage. The tax is calculated by using the total cost of insurance and insurance-related coverage, whether paid by the employee or the employer. This means that the insurance premiums paid by the employer, the insurance premiums paid by the employee, the money paid into flexible spending accounts, the money paid into health savings accounts, and the money paid into medical savings accounts are all aggregated. If the aggregate amount exceeds \$10,200 for self-only coverage or exceeds \$27,500 for other than self-only coverage, the excess benefit is subject to an excise tax of 40 percent of the excess benefit. The threshold amounts are increased by \$1,650 for certain older employees and by \$3,450 for employees in high-risk occupations (i.e., mining, law enforcement, etc.). This excise tax must be computed by employers but it may be levied on the employer directly or on the insurance provider depending on the circumstances and the insurance policy. The excise tax applies to tax years beginning in 2018 and thereafter with the threshold amounts indexed for inflation beginning in 2019.

*Tax Planning Tips:* This excise tax does not take effect for several more years. Currently most employers should not be affected by this tax due to the threshold levels. This tax is designed to penalize the so-called “Cadillac plans.” No one knows what will happen to health care costs over the next several years, but it is sure to rise above current levels; so employers should proceed with caution into the future as they select health care plans for their employees.

### SIMPLE CAFETERIA PLANS FOR SMALL BUSINESSES

Section 9022 of the Act amends Section 125 of the Internal Revenue Code of 1986 to add a new section “(j)” which is entitled “Simple Cafeteria Plans for Small Businesses.” These “simple” plans are available for “eligible employers.” An “eligible employer” is defined as a business that employed an average of 100 or fewer employees on business days during either of the two preceding years. If a business did not exist in prior years, the business must estimate how many employees it will use during the current year. All employees who work 1,000 hours or more per year must be allowed to participate in the simple cafeteria plan and be eligible for any benefits available under the plan. In addition, a growing small business that establishes a simple cafeteria plan is allowed to continue to participate until the number of employees reaches 200. When a company employs 200 or more eligible employees, the cafeteria plan must meet all of the usual requirements for cafeteria plans.

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Simple cafeteria plans do not have to meet the non-discrimination requirements of Internal Revenue Code Section 125. One of the major restrictions on cafeteria plans under Code Section 125 that made these plans unavailable to small business in the past is the 25 percent concentration rule under paragraph 125(b). Paragraph 125(b) states that “key employee” benefits cannot exceed 25 percent of the non-taxable benefits received by all employees under the plan. The 25 percent rule is essentially waived for these new simple cafeteria plans. For example, if a business has 10 employees with four being “key employees” and six being non-key employees and all 10 employees receive the same benefits; the plan would fail the 25 percent concentration test because 40 percent of the benefits (more than 25 percent) are being received by key employees. Under the new rules, the 25 percent rule is waived or considered to be met for eligible small employers. Generally, a more than five-percent owner, an officer earning more than \$160,000, and a one-percent owner receiving more than \$150,000 in compensation are defined as key employees. The new rules that establish simple cafeteria plans go into effect on Jan. 1, 2011.

*Tax Planning Tip:* Since the new simple cafeteria plan is for small employers and covers all “eligible employees,” this law will primarily benefit C corporations. Sole proprietors, partners and limited liability company owners appear to have been neglected by this new law since they are not “employees.” Therefore, some small businesses may consider changing the form of ownership to a C corporation based on advice of their attorneys and or accountants.

### **CODIFICATION OF ECONOMIC SUBSTANCE DOCTRINE**

The Economic Substance Doctrine (sometimes referred to as the Business Purpose Doctrine) is a judicially created common law rule that generally provides that a business transaction whose sole purpose is to reduce federal income tax will be disallowed for federal tax purposes. In other words, business transactions must be entered into for a business reason or a profit motive, not just to reduce federal income tax. This Doctrine has been used in the past primarily to deal with tax shelters.

Since the various courts in the United States have applied this Doctrine using different tests and standards (which led to uncertainty), the Act codifies the Doctrine in new Internal Revenue Code paragraph 7701(o). The new rules are effective for transactions entered into after March 31, 2010. A transaction is considered to have

economic substance if it changes in a meaningful way the taxpayer’s economic position and the taxpayer has a substantial purpose (other than to reduce federal income tax) for entering into the transaction. Transactions involving forming a new business and choosing debt versus equity in financing a business should not be affected by the new law.<sup>1</sup>

*Tax Planning Tip:* The new law imposes a penalty of 40 percent on business transactions that lack economic substance. Therefore, taxpayers should make sure that questionable transactions are entered into for economic reasons as well as tax reasons.

### **NEW MEDICARE TAXES**

The Act imposes two new Medicare taxes on various taxpayers. The first new Medicare tax affects “high-income” taxpayers with wages received from employment. Any wages received in excess of \$250,000 in the case of a joint return, \$125,000 in the case of married filing separately, or \$200,000 in the case of other taxpayers is subject to an additional Medicare tax of .9 percent. The additional tax is also imposed on self-employment income from all self-employed taxpayers other than corporations, estates and trusts. This high-income Medicare tax takes effect on income earned after Dec. 31, 2012.

The Act also imposes a new Medicare tax on unearned income. The tax on individuals is imposed at 3.8 percent on the lesser of the individual’s net investment income for the year or the amount of the individual’s modified adjusted gross income that exceeds a threshold amount. The threshold amount is \$250,000 for a married taxpayer filing a joint return, \$125,000 for a married taxpayer filing a separate return, and \$200,000 for all other individuals. The new Medicare tax is also imposed on estates and trusts on the lesser of their undistributed net investment income or their adjusted gross income that exceeds the threshold amounts discussed above. This provision will particularly penalize real estate investors.

Net investment income is defined as the sum of gross income from rents, royalties, interest, dividends and annuities, minus deductions properly allocable to that income. Net investment income also includes a trade or business that is a passive activity and a trade or business involving the buying and selling of financial instruments or commodities. Finally, net investment income includes net gains from the disposition of property other than property held in a trade or business (i.e., net capital gains). Exempt from this tax is interest on tax-exempt

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bonds, veterans' benefits, and gain on sale of principal residence. This additional tax applies to income from transactions occurring after Dec. 31, 2012.<sup>2</sup>

*Tax Planning Tips:* These taxes must be included in a taxpayer's estimated tax payments, and the taxes are not deductible for federal income tax purposes. Taxpayers who have businesses that are passive but almost meet the appropriate threshold to be reclassified as active should consider altering income-producing activities to make the trade or business become classified as active. Taxpayers should also consider investing in tax-exempt bonds. Individuals who can shelter taxable income through retirement contributions should consider making maximum allowable tax-sheltered contributions to their retirement accounts to lower their taxable income levels and their adjusted gross income.<sup>3</sup>

## SMALL BUSINESS TAX CREDIT

New Section 45R is inserted into the Internal Revenue Code of 1986 where other business-related tax credits are discussed. Section 45R adds a credit for "employee health insurance expenses of small employers." An eligible small employer is defined for this Section as an employer with 25 or fewer employees and average annual wages of \$50,000 or less. These small businesses would be eligible for a credit of up to 50 percent of the contributions the businesses make on behalf of their employees for health insurance premiums. From 2010–2013, the maximum credit is 35 percent of the employer's eligible health insurance premium expense. Beginning in 2014, the full 50 percent credit will be available. Employers will not be allowed to take both an expense deduction and the credit for the same dollars.<sup>4</sup>

Employers with 10 or fewer employees and average annual wages of \$25,000 or less will receive the full credit. For employers with more than 10 employees or average annual wages of more than \$25,000, the credit will be phased out so that employers with more than 25 employees or average annual wages higher than \$50,000 will lose the credit completely. The amount of the credit is reduced (but not below zero) by the sum of the following amounts: (1) the amount of the credit multiplied by a fraction where the numerator is the total number of full-time equivalent employees of the employer in excess of 10 and the denominator is 15 plus; (2) the amount of the credit multiplied by a fraction where the numerator is the average annual wages of the employer in excess of \$25,000 and the denominator is \$25,000. For example, an

employer with 16 employees would lose 40 percent of the available credit (16-10/15). Also, an employer with average annual wages of \$30,000 would lose 20 percent of the available credit (\$30,000-\$25,000/\$25,000). Lastly, an employer with 16 employees and average annual wages of \$30,000 would lose 60 percent of the available credit (40 percent + 20 percent).

## OTHER PROVISIONS OF HEALTH CARE REFORM

### Business Information Reporting

Congress expanded the form 1099-MISC reporting requirements as part of the Act. Under the Act, all payments totaling \$600 or more in a calendar year to a corporation (other than a tax-exempt corporation) must be reported to the Internal Revenue Service using form 1099-MISC. Under prior law, taxpayers were not required to provide 1099s when they paid for property or services purchased from a corporation. This new law requires reporting all payments totaling \$600 or more except for payment for securities and brokerage transactions.<sup>5</sup> An exception is made for payments made by credit cards and debit cards. This information reporting provision could prove very burdensome for small businesses. This provision is effective for tax years beginning after Dec. 31, 2011.

### Modification of Itemized Deduction for Medical Expenses

Subsection (a) of section 213 of the Internal Revenue Code of 1986 is amended by striking "7.5 percent" and inserting "10 percent" as the new deductible threshold for medical expenses on Schedule A for itemized deductions. In other words, only medical expenses that exceed 10 percent of adjusted gross income will be deductible on Schedule A. The amendments to this subsection apply to tax years beginning after Dec. 31, 2012. The Act does give a tax break to seniors (taxpayers 65 or older) by allowing the deductible threshold to remain at 7.5 percent for tax years from 2013 through 2016.

### Limitation on Health Flexible Spending Arrangements

The Act established a new uniform standard that, effective Jan. 1, 2011, applies to Flexible Spending Arrangements (FSAs) and Health Reimbursement Arrangements. Under the new standard, the cost of an over-the-counter medicine or drug cannot be reimbursed from the account unless a prescription is obtained. The change does not affect insulin, even if purchased without a prescription, or other health care expenses such as medical devices, eyeglasses, contact lenses, co-pays and

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deductibles. The new standard applies only to purchases made on or after Jan. 1, 2011, so claims for medicines or drugs purchased without a prescription in 2010 can still be reimbursed in 2011, if allowed by the employer's plan. In addition, the Act lowered the maximum contribution to an FSA from the current \$5,000 per year to a maximum of \$2,500 per year. This \$2,500 maximum is effective for tax years beginning in 2013. The maximum amount is adjusted for inflation in 2014 and later years.

## W-2 Reporting

The Act requires an employer to report on each employee's W-2 form the value of the employee's health insurance coverage provided by the employer. The employer must include not only health insurance, but also must include dental coverage and vision plan coverage. To calculate the value of the health care coverage, the employer would use the value of equivalent COBRA coverage. This provision is effective beginning in 2011.<sup>6</sup>

## Implementation Schedule of Selected Tax Changes:

- 2010** Small business tax credit  
Economic substance doctrine codified
- 2011** W-2 reporting of health insurance coverage  
Simple cafeteria plans
- 2012** 1099s for payments to corporations  
Adoption credit expires
- 2013** 3.8 percent Medicare tax on unearned income  
.9 percent Medicare tax on high-income taxpayers  
Decrease in flexible spending arrangement maximum
- 2014** Excise tax on uninsured individuals  
Employer health coverage penalties
- 2018** Tax on high-cost employer plans

## CONCLUSION

This article summarizes some of the changes in the Patient Protection and Affordable Care Act of 2010 and the Health Care and Education Reconciliation Act of 2010. The focus is on the changes that would directly or indirectly affect real estate investors and/or small businesses. The author sees no movement toward tax simplification by the U.S. Congress and the president. These new laws create greater tax burdens and greater reporting burdens on numerous taxpayers. Real estate investors and small business owners should review the new laws to determine how the new rules will affect their tax burdens and business operations. In fact, a law as complicated as this Act commands a great deal of study by investors and small business owners who desire to maximize returns and minimize the tax burden while being mindful of the Economic Substance Doctrine discussed above. Taxpayers should consult with appropriate tax professionals to assure proper application and maximum benefit from this new tax Act. ■

## ENDNOTES

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6. PricewaterhouseCoopers, "Comprehensive Health Care Reform Legislation with Significant Tax Provisions Enacted into Law," *Washington National Tax Insight* (March 30, 2010), pp. 1-20.