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flash International Executive Alert

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United States – Supreme Court Issues Decision on Health Care Reform Legislation

by KPMG LLP's Washington National Tax practice, Washington, D.C. (KPMG LLP in the United States is a KPMG International member firm)

On June 28, 2012, the U.S. Supreme Court released its decision concerning the constitutionality of provisions of the health care reform legislation of 2010.[1] The Court upheld the constitutionality of the major provisions of the legislation, including the individual mandate to purchase health insurance. The Court modified certain provisions of the legislation relating to the federal governments' ability to withhold funds from states under the Medicaid program.

This *Flash International Executive Alert* focuses on certain tax provisions included in the health care reform legislation that are now due to go into effect as of January 1, 2013, and are likely to have a significant impact on globally mobile employees and their multinational employers.

In Brief: Background and Context

The 2010 health care legislation includes the *Patient Protection and Affordable Care Act*, signed by the president on March 23, 2010, and the *Health Care and Education Reconciliation Act of 2010,* which modified the revenue provisions of the Affordable Care Act and was signed by the president on March 30, 2010.

Various changes to the Internal Revenue Code were made to offset part of the cost of health care reform. Among the revenue raisers that may impact globally mobile employees and their multinational employers are:

- A 3.8-percent health insurance tax on passive investment income;
- 0.9-percent increase in the health insurance tax on wage income, for individuals earning more than $200,000 and couples earning more than $250,000.

The relationship between assignment-related allowances and tax rates is a key driver of international assignment program costs. If an employer has in place a tax reimbursement policy for its international assignees, the employer will generally reimburse the assignee for taxes on elements of compensation such as allowances for housing, cost of living, and so forth. Because such allowances – and the tax reimbursements on them – increase taxable income, the assignee may be in a higher tax bracket than he or she would be otherwise, and may lose the benefit of certain deductions.

Higher compensation may expose the assignee to the two new health care taxes, which may have an impact on tax reimbursement practices and tax-related assignment costs. Following the Supreme Court decision, these taxes will go into effect for 2013 (absent further Congressional action).

Additional Hospital Insurance Tax on High-Income Taxpayers

One of the two new taxes is an increase to the FICA[2] Medicare tax of 0.9 percent on compensation in excess of a threshold amount (the "hospital insurance tax"). Single taxpayers are subject to the hospital insurance tax on compensation in excess of $200,000, while married taxpayers filing jointly are subject to the tax when the compensation of both spouses together exceeds $250,000. (Married taxpayers filing separately are subject to the tax on compensation in excess of $125,000.) These thresholds will not be adjusted for inflation.

Employers are required to withhold the hospital insurance tax when an employee's annual compensation exceeds $200,000, regardless of that employee's marital status, which means that married taxpayers could find themselves under-withheld or over-withheld. If an employee is under-withheld, then the amount due should be paid with the employee's tax return and the employee may be subject to penalty for under-payment of estimated taxes. If an employee is over-withheld, then the amount over-withheld is treated as an income tax credit and may be refundable.

Although the hospital insurance tax is characterized as being part of FICA, the tax is assessed to the employee only – there is no corresponding employer tax.

Some foreign nationals in the U.S. are exempt from FICA due to a Certificate of Coverage under their home country's Social Security Totalization Agreement with the United States. In these situations, it appears that the exemption will shelter the foreign national from the hospital insurance tax as well. (The Internal Revenue Service (IRS) has not yet confirmed this conclusion.)

Medicare Tax on Investment Income

The second new tax added by the health care reform legislation is the Medicare tax on investment income. Although called a "Medicare tax," it is not considered to be part of FICA, is not withheld by the employer, and is not assessed on employee compensation. Instead, this 3.8-percent tax is due on "net investment income" if the taxpayer's modified adjusted gross income (MAGI) exceeds $200,000 for a single taxpayer or $250,000 for a married couple filing jointly ($125,000 on a married filing separate return). As with the thresholds for the new hospital insurance tax, these thresholds will not be adjusted for inflation, which means, over time, more and more people will be brought within the scope of this tax. MAGI is defined as adjusted gross income increased by any foreign earned income exclusion that was claimed by the taxpayer. Net investment income is investment income (including dividends, interest, annuities, rents and royalties, and gains from the disposition of investment property) reduced by deductions related to such income.

The 3.8-percent tax is assessed on the lesser of net investment income or the amount by which MAGI exceeds the threshold amount described above. Unlike the hospital insurance tax, it does not appear that the Medicare tax on investment income will be covered by Social Security Totalization Agreements, meaning that a foreign national who is working in the United States and has a Certificate of Coverage may be subject to this tax. (The IRS has not yet confirmed this conclusion.)

Individual Mandate to Purchase Health Insurance

Now that most provisions of the health care legislation have been affirmed, employees may also have questions regarding the health insurance mandate and its related penalty for non-compliance. Most employers large enough to have an international assignee population likely offer employer-sponsored health insurance plans. If an employer-sponsored plan is available, it seems justifiable that the employer would not be required under a tax equalization policy to subsidize the “penalty” for lack of insurance. On the other hand, if an employer does not sponsor any health insurance plans for its employees, it would seem to be equally unreasonable for that employer to have to subsidize the penalty imposed on an employee for lack of insurance, since the employees on international assignment would be in no worse position than the domestic employees.

KPMG Note

For employers with no international assignment programs, the introduction of the new health care taxes may mean simply preparing to withhold the new hospital insurance tax. For employers with international assignment programs that include a tax reimbursement policy, there may be much more to address.

Update Tax Reimbursement Policy -- Under most “tax equalization” policies, the assignee is responsible for a “theoretical tax” amount that approximates what the assignee’s tax burden would have been without the assignment, and the employer is responsible for any additional tax. However, many policies place a limit on the amount of “personal” or “outside” income that will be covered – if the assignee’s non-compensation income is higher than some threshold, he or she will be personally responsible for all taxes related to that income.

Although only two percent of U.S. households have income over $250,000,[3] it is commonly accepted that a much higher percentage of those on employer-sponsored international assignments have such income levels, meaning that many assignees will be subject to the new health care taxes. Many of those assignees may expect to be reimbursed for the new tax liability by their employers. If the much-discussed “Bush tax cuts” are allowed to expire in 2013, higher marginal rates combined with the new hospital insurance tax and the Medicare tax on investment income could mean a tax increase of up to 8.4 percentage points,[4] giving a greater-than-ever incentive to put in place – and enforce – a limitation on the amount of personal income subject to tax equalization. This is a common practice that is employed to limit the employer’s overall assignment cost.

Communicate to Employees -- With the new health care taxes now due to take effect, employers can expect a great deal of discussion about them in the media in the months to come. Pro-active communication to assignees regarding how the company’s international assignment policy will handle these taxes may lessen anxiety. Policy changes may be more likely to be accepted if decisions are made before the topic becomes controversial. Moreover, decisions made under pressure may not serve the long-term goals of the company.

KPMG Note (cont'd)

Adjust Cost Accruals -- Depending on the size of an assignee population, and depending on the average compensation level of the assignees, the impact of the two new health care taxes on overall international assignment program costs could be virtually nil – or it could be quite significant. To avoid surprises, program managers may wish to re-calculate assignment cost projections, particularly when there are significant balance sheet accruals or contract pricing to consider.

Impact on Hypothetical Tax -- It is not unusual for employers of international assignees to withhold hypothetical income tax,[5] but withhold actual (not hypothetical) FICA. Such employers will need to decide how the two new taxes fit into this scheme. It may be most logical to treat the 0.9-percent tax on compensation as part of FICA, but the 3.8-percent tax on net investment income as an addition to income tax. Note that there are compliance and cash-flow considerations that are often overlooked in deciding whether to implement hypothetical FICA withholding, but that discussion is outside the scope of this newsletter.

Footnotes:

1 *United States Department of Health and Human Services, et. al. v State of Florida, et. al.* Text of the decision is posted on the KPMG Web site: Supreme Court (June 28)

Alternatively, text of the decision is available on the Supreme Court's Web site at: http://www.supremecourt.gov/opinions/slipopinions.aspx .

2 The Federal Insurance Contributions Act (FICA), which resulted from the Social Security Act of 1935, is legislation that requires employers to set aside or withhold a set percentage amount from employees' wages each pay period; it also requires employers to match that amount and contribute both amounts to a government account known as the Social Security Trust Fund. The Fund provides eligible individuals with various benefits such as retirement income, disability insurance, Medicare, and survivors' benefits.

3 *2012 Statistical Abstract*, United States Census Bureau.

4 If the "Bush tax cuts" expire, the highest marginal income tax rate will increase to 39.6 percent from the current 35 percent. This increase of 4.6 percentage points, combined with the new 3.8 percent Medicare tax on investment income, means that tax rate on investment income of high-income taxpayers could increase by 8.4 percentage points.

5 Under a typical tax equalization program, the employer will withhold from the employee's pay "hypothetical tax," which is meant to approximate what the employee's withholding amount would have been had he or she not been on international assignment. In return, the employer pays the employee's actual taxes on his or her behalf. Some employers extend this methodology to social security taxes, while others limit it only to income tax.

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