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Long-term effects

The health care industry is still wrestling with changes from the 2017 tax law

By: Martin Daks
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Christine Kachinsky, partner, KPMG LLP. – AARON HOUSTON

When the 2017 tax law took effect, many businesses and advisers had to scramble to digest multiple changes to deductions, depreciation, expensing, tax credits and other matters. Two years on, hospitals and other organizations are still grappling with the landmark legislation, especially since some of its provisions — as well as some Obama-era changes —are just now coming into play.

One significant issue is the law's 21 percent excise tax on compensation of more than $1 million paid by a tax-exempt organization to certain employees for tax years beginning after Dec. 31, 2017. "We are still waiting for proposed regulations for answers to many questions about the application of this provision," said Christine Kachinsky, a partner at KPMG LLP who leads the New Jersey tax practice at the multinational audit, tax and advisory services firm. "Because most fiscal year taxpayers — for example ones with tax years ending June 30 or Sept. 30 — would not have included a full year of employee compensation when determining whether the $1 million threshold was crossed, or by how much, the excise tax for the first year may not have been as significant as it will be in coming years. For tax years beginning in 2019, all affected taxpayer organizations will have to pay tax on all compensation in excess of $1 million paid in 2019 — so that amount is likely to be more significant."

But organizations may be able to minimize or avoid the excise tax with proper planning, said Marc Berger, national director, Nonprofit Tax Services at BDO, an international assurance, tax, and financial advisory services firm. “Some hospitals and other nonprofits are considering restructuring the nonqualified deferred compensation arrangements of some executives,” he said. “This way they would vest and become taxable in different years, in order to keep the ‘covered employees’ below the triggering compensation level.”

Hospitals get hit with UBIT

The 2017 law also added some wrinkles for unrelated business income or income from a trade or business that’s regularly carried on but is not substantially related to the charitable, educational or other purpose that is the basis of the organization’s exemption. “The act added two new UBIT [unrelated business income tax] rules,” Kachinsky said. “One was a new tax on qualified transportation fringe benefits [like mass transit, parking, and vanpooling reimbursements]; and the other was a requirement to compute UBIT separately for each unrelated trade or business.”

For hospital systems in urban areas, the tax hit on qualified fringe benefits levied by section 512(a)(7) of the law “has been very significant due to large expenditures on mass transit passes as well as employee parking expenses,” she added. “In some urban areas, local laws predating the changes made by the tax act require employers to provide employees with the tax-advantaged mass transportation benefits that are now subject to tax.”

Because the tax on transportation fringe benefits is levied against the nonprofit, “organizations could try to restructure the benefits as additional taxable compensation to the employee, which would shift the tax burden to the employees instead of the nonprofit hospital or other organization,” said Berger. “But I haven’t seen many organizations strongly consider moving in that direction and there is some bipartisan support in Congress to repeal this provision.”

Separately, the provision to compute UBIT separately for each trade or business, under Section 512(a)(6), “might cause healthcare organizations to think about restructuring their businesses – like putting a money-losing and money-making unrelated trade or business together into one taxable subsidiary,” Kachinsky said. “But restructuring would raise a host of tax and non-tax issues, so while there may be situations where restructuring is both possible and desirable, we haven’t run into them yet.”

Hospitals that conduct outside lab activity – like drawing and analyzing blood samples on behalf of non-patients – could be affected by the new UBIT provisions, according to BDO’s Berger. “Since profit and loss must now be computed separately, on a ‘silo’ basis for each unrelated business, any losses incurred for an activity will not be deductible in the current year, but instead must be carried forward to future years; and are only deductible against future income from that particular activity,” he said. “Under the new law, losses can be carried forward indefinitely, but may not be carried back.”

A different provision, from the Obama-era Affordable Care Act, may affect health insurers this year, noted David Green, a partner with Deloitte Tax LLP who also serves as life sciences and health care industry leader. “The Medical Loss Ratio requirement of the ACA limits the portion of premium dollars health insurers may use for administration, marketing, and profits,” he said. “Due to the receipt of certain tax refunds, some healthcare insurance plans are finding that their Medical Loss Ratio is decreasing, and therefore may be providing rebates back to policyholders for a portion of their premiums.”

Assessing the ACA effect

Health care coverage costs may increase in January, thanks to another ACA rule that imposes a fee on each covered entity engaged in the business of providing health insurance for U.S. health risks. There was a moratorium on the fee for 2017 and there was a suspension on the fee for 2019, according to the IRS, but the moratorium “will end Dec. 31, 2019, unless it is extended by legislation,” Green added.

“Health insurers are set to pay $16 billion for 2020, which may give rise to premium increases on policyholders if the moratorium is not extended. In prior years, when the fee was collected, we observed an increase in premiums. Finally, the ‘Cadillac Tax’ on certain [benefit-rich] health insurance policies was originally scheduled to be in effect in 2018 and has been delayed twice. The current implementation date is 2022.”

Another holdover from the ACA, the Medical Device Excise Tax, may also come back to haunt healthcare companies. Originally designed to help cover the cost of Obamacare, the tax is a 2.3 percent excise on the value of medical devices sold domestically. Although it went into effect in 2013, the tax was repeatedly suspended by Congress beginning in 2016. The latest moratorium, however, “is set to expire Dec. 31, unless Congress takes action to extend it or repeal the tax outright,” Kachinsky noted. “Companies we’ve spoken with are certainly focused on the fate of the medical device excise tax. There are concerns that broader political environment and the narrow time window to the end of the year adds to the uncertainty about a repeal or a new moratorium.”

During the time the tax was in effect, “it negatively affected medical device companies,” according to a study cited by The Tax Foundation, a libertarian-leaning nonprofit research organization. “Research and development (R&D) was reduced by $34 million in 2013,” the study noted, while “the administration of and compliance with the tax filings associated with the medical device excise tax was a significant undertaking for those companies impacted.”

Life sciences companies in New Jersey and elsewhere could also be facing a tax threat that strikes at the heart of their competitive advantage: research and development. “R&D, which is currently deductible when incurred, may be the largest expense item for some of these companies,” noted KPMG’s Kachinsky.

But beginning in 2022, "R&D will need to be capitalized and U.S. R&D expenses will be deductible over a five-year period, while those incurred overseas will be deducted over a much-longer 15-year period. This is expected to wreak havoc on the tax liability for some, such as those receiving revenue or reimbursement currently in a collaboration or similar co-development agreement in year one that won't be able to deduct related expenses until several years later under those collaborations."

An Rx for tax changes

A startup pharmaceutical company in Central Jersey was originally structured as an LLC that elected to be taxed as a partnership, but "we recently advised the owners to convert to being taxed as a "C" corporation," said Vinay Navani, a shareholder in the CPA and advisory firm WilkinGuttlenplan. "The Tax Cuts and Jobs Act reduced the tax rate on C-corps to a flat rate of 21 percent, which is lower than the highest individual rate of 37 percent, so that got a lot of conversations started," he said. "Also, an existing section of the Internal Revenue Code, Section 1202, may enable owners of startups and other small businesses organized as corporations to exclude up to $10 million of gain when they sell the company. This is a big deal for startups. In this case, when our client was looking to exit in about five to seven years, the scales were tipped to shift to a "C" corporate tax structure."

Forman

The 2017 tax law also slashed a tax credit for certain research and development expenses related to "orphan drugs" — specialty treatments designed to address rare medical conditions — from 50 percent to 25 percent. It sounds pretty bad, but "the tax tail doesn't wag the dog," said Jonathan Forman, Northeast regional leader of R&D Tax Services at the accounting and advisory firm BDO. "Based on Food and Drug Administration numbers, the number of applications for orphan drug designation requests has held pretty steady pre-TCJA and post-TCJA," he said. "In particular, the credit really hasn't made much of a difference for many startups, which tend to be pre-revenue, anyway."

Also, many of the orphan drug development programs "have been ongoing for a number of years and companies may hesitate in curtailing these investments if they are close to approval," noted Christine Kachinsky, a partner at KPMG LLP who leads the New Jersey tax practice at the global audit, tax and advisory services firm. "Based on data provided by the FDA, 2017 was unusually an high year for active orphan drug designations with just under 500 active designations. The number of designations in 2018 and 2019 appears to have declined

— less than 350 — however, this is consistent with the pre-2017 numbers. Time will tell as to the longer-term impact this will have on the number of new orphan drug indications being evaluated."

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