JOINT COMMITTEE ON TAXATION
July 16, 2009
JCX-32-09

DESCRIPTION OF AN AMENDMENT IN THE NATURE OF A SUBSTITUTE TO THE PROVISIONS OF H.R. 3200, THE "AMERICA'S AFFORDABLE HEALTH CHOICES ACT OF 2009"

The Chairman's amendment in the nature of a substitute corrects one typographical error and adds the following proposals to H.R. 3200.

I. REFORM PROPOSALS

A. Tax on Individuals Without Acceptable Health Care Coverage

1. On page 3 of JCX-30-09, in the second line, letter (b) should be "2.5" percent rather than "two" percent.

2. The modification clarifies the definition of qualifying child. It provides a special rule under which a child is treated as a qualifying child of an individual if such individual is required to provide such health care coverage pursuant to a child support order.[1]

B. Credit for Small Business Employee Health Coverage Expenses

The chairman's modification clarifies that the small business employee health coverage credit is only available for employees performing services in a trade or business.

II. OTHER REVENUE PROVISIONS

A. Clarification of the Definition of Modified Adjusted Gross Income for Purposes of the Surcharge

The modification clarifies that modified adjusted gross income means adjusted gross income reduced by the amount of the deduction for investment interest which is an itemized deduction.

[1] The proposal does not modify the present-law dependency exemption.

B. Modify the Definition of Qualified Medical Expenses for Purposes of HRAs, Health FSAs, HSAs, and Archer MSAs

Present Law

Any amounts paid during a taxable year for medicine or drugs are deductible as a medical expense under the rules relating to itemized medical expenses only if the medicine or drug is a prescribed drug or is insulin.[2] Thus, any amount paid for over-the-counter medicine is not deductible as a medical expense. However, under a Health Reimbursement Arrangement ("HRA") or under a Health Flexible Spending Arrangement ("Health FSA") under a cafeteria plan, amounts paid for over-the-counter medicine are treated as medical expenses, and reimbursement for such amounts are excludible from gross income. Similarly, a distribution from a Health Savings Account ("HSA") or an Archer MSA used to purchase over-the-counter medicine is excludible as an amount used for qualified medical expenses.[3]

Description of Proposal

Under the proposal, with respect to medicines, the definition of medical expense for purposes of HRAs, Health FSAs, HSAs, and Archer MSAs is conformed to the definition for purposes of the itemized deduction for medical expenses. Thus, under the proposal, the cost of over-the-counter medicines may not be reimbursed with excludible income through a Health FSA, HRA, or HSA.

Effective Date

The proposal is effective for expenses incurred after December 31, 2009.

C. Certain Health Related Benefits Applicable to Spouses and Dependents Extended To Eligible Designated Beneficiaries

Present Law

Definition of dependent for exclusion for employer-provided health coverage

The Code generally provides that employees are not taxed on (that is, may "exclude" from gross income) the value of employer-provided health coverage under an accident or health plan.[4] In addition, any reimbursements under an accident or health plan for medical care expenses for employees, their spouses, and their dependents (as defined in section 152) generally

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[2] Sec. 213(b).

[3] Sec. 105(b) provides that reimbursements for medical care within the meaning of section 213(d) pursuant to employer provided health coverage are excludible from gross income. The definition of medical care in section 213(d) does not include the prescription drug limitation in section 213(b).

[4] Sec 106.

are excluded from gross income.[5] Section 152 defines a dependant as a qualifying child or qualifying relative.

Under section 152(c), a child generally is a qualifying child of a taxpayer if the child satisfies each of five tests for the taxable year: (1) the child has the same principal place of abode as the taxpayer for more than one-half of the taxable year; (2) the child has a specified relationship to the taxpayer; (3) the child has not yet attained a specified age; (4) the child has not provided over one-half of their own support for the calendar year in which the taxable year of the taxpayer begins; and (5) the qualifying child has not filed a joint return (other than for a claim of refund) with their spouse for the taxable year beginning in the calendar year in which the taxable year of the taxpayer begins. A tie-breaking rule applies if more than one taxpayer claims a child as a qualifying child. The specified relationship is that the child is the taxpayer's son, daughter, stepson, stepdaughter, brother, sister, stepbrother, stepsister, or a descendant of any such individual. With respect to the specified age, a child must be under age 19 (or under age 24 in the case of a full-time student). However, no age limit applies with respect to individuals who are totally and permanently disabled within the meaning of section 22(e)(3) at any time during the calendar year. Other rules may apply.

Under section 152(d) a qualifying relative means an individual that satisfies four tests for the taxable year: (1) the individual bears a specified relationship to the taxpayer; (2) the individual's gross income for the calendar year in which such taxable year begins is less than the exemption amount under section 151(d); (3) the taxpayer provides more than one-half the individual's support for the calendar year in which the taxable year begins; and (4) the individual is not a qualifying child of the taxpayer or any other taxpayer for any taxable year beginning in the calendar year in which such taxable year begins. The specified relation test for qualifying relative is satisfied if that individual is the taxpayer's: (1) child or descendant of a child; (2) brother, sister, stepbrother or stepsister; (3) father, mother or ancestor of either; (4) stepfather or stepmother; (5) niece or nephew; (6) aunt or uncle; (7) in-law; or (8) certain other individuals, who for the taxable year of the taxpayer, have the same principal place of abode as the taxpayer and are a member of the taxpayer's household.[6]

Employers may agree to reimburse medical expenses of their employees (and their spouses and dependents), not covered by a health insurance plan, through flexible spending arrangements which allow reimbursement not in excess of a specified dollar amount (either elected by an employee under a cafeteria plan or otherwise specified by the employer). Reimbursements under these arrangements are also excludible from gross income as employer-provided health coverage. The same definition of dependents applies for purposes of flexible spending arrangements.

A similar rule excludes employer provided health insurance coverage and reimbursements for medical expenses for employees, their spouses, and their dependents from

[5] Sec. 105(b).

[6] Generally, same-sex partners do not qualify as dependants under section 152. In addition, same-sex partners are not recognized as spouses for purposes of the Code. Defense of Marriage Act, Pub. L. No. 104-199.

the employees' wages for payroll tax purposes.[7] The same definition of dependent applies for purposes of this exclusion.

Deduction for Health Insurance Premiums of Self-Employed Individuals

Under present law, self-employed individuals may deduct the cost of health insurance for themselves and their spouses and dependents. The deduction is not available for any month in which the self-employed individual is eligible to participate in an employer-subsidized health plan. Moreover, the deduction may not exceed the individual's self-employment income. The deduction applies only to the cost of insurance (i.e., it does not apply to out-of-pocket expenses that are not reimbursed by insurance). The deduction does not apply for self-employment tax purposes. For purposes of the deduction, a more than two percent shareholder-employee of an S corporation is treated the same as a self-employed individual. Thus, the exclusion for employer-provided health care coverage does not apply to such individuals, but they are entitled to the deduction for health insurance costs as if they were self- employed.

Voluntary Employees' Beneficiary Associations

A voluntary employees' beneficiary association ("VEBA") is a tax-exempt entity that is a part of a plan for providing life, sick or accident benefits to its members or their dependents or designated beneficiaries.[8] No part of the net earnings of the association inures (other than through the payment of life, sick, accident or other benefits) to the benefit of any private shareholder or individual. A VEBA may be funded with employer contributions or employee contributions or a combination of employer contributions and employee contributions. The same definition for dependent applies for purposes of receipt of medical benefits through a VEBA.

Description of Proposal

Exclusion for employer-provided health coverage

The proposal amends sections 105 and 106 to extend the general exclusion for employer-provided health coverage to "eligible beneficiaries."[9] The parallel provisions for excluding employer-provided health care from payroll taxes are also amended.[10] An eligible beneficiary is defined as any individual who is eligible to receive benefits or coverage under an accident or health plan. The proposal does not place a limit on the number of eligible beneficiaries an individual is able to claim for purposes of the exclusion.

The proposal directs the Secretary of the Treasury to issue guidance providing that eligibility for reimbursements from Flexible Spending Arrangements ("FSAs") and Health

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[7] Sec. 3121(a)(2), and 3306(a)(2).

[8] Secs. 419(e) and 501(c)(9).

[9] The proposal does not modify the present-law dependency exemption.

[10] Secs. 3121(a)(2), 3231(e)(1), 3306(b)(2), 3401(a)(24).

Reimbursement Arrangements ("HRAs") is extended to otherwise qualifying medical expenses of any eligible beneficiary.

A parallel change is made for Voluntary Employees' Beneficiary Associations ("VEBAs").

Deduction for Health Insurance Premiums of Self-Employed Individuals

The proposal amends section 162(l) to permit self-employed individuals to take a deduction for an individual who meet the following criteria: (1) younger than age 19 (24 for full-time students); (2) has the same principal abode as the taxpayer and is a member of the taxpayer's household for the taxable year; and (3) receives more than one-half of his or her support from the taxpayer for the calendar year in which the taxable year begins. The proposal does not place a limit on the number of such individuals a taxpayer is able to claim for purposes of the deduction.

The proposal also permits a self-employed individual to take a deduction for an individual who is (1) older than age 19 (or 24 for students); (2) has the same principal abode as the taxpayer and is a member of the taxpayer's household for the taxable year; and (3) is not the individual's spouse, qualifying child or qualifying relative. Individuals may only take a deduction for one such individual in any tax year.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2009.