# DESCRIPTION OF HEALTH-RELATED TAX PROPOSALS

Scheduled for Markup

before the

Health Subcommittee of the

House Committee on Ways and Means

on June 4, 1997

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

June 3, 1997

JCX-17- 97

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# INTRODUCTION

This document[1] contains descriptions of health-related tax proposals scheduled for markup in the Health Subcommittee of the House Committee on Ways and Means on June 4, 1997.

[1] This document may be cited as Joint Committee on Taxation, *Description of Health-Related Tax Proposals* (JCX-17-97)(June 4, 1997).

## 1. Tax Treatment of Hospitals Which Participate in Provider-Sponsored Organizations

### Present Law

To qualify as a charitable tax-exempt organization described in Internal Revenue Code (the "Code") section 501(c)(3), an organization must be organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster international sports competition, or for the prevention of cruelty to children or animals. Although section 501(c)(3) does not specifically mention furnishing medical care and operating a nonprofit hospital, such activities have long been considered to further charitable purposes, provided that the organization benefits the community as a whole.[2]

No part of the net earnings of a 501(c)(3) organization may inure to the benefit of any private shareholder or individual. No substantial part of the activities of a 501(c)(3) organization may consist of carrying on propaganda, or otherwise attempting to influence legislation, and such organization may not participate in, or intervene in, any political campaign on behalf of (or in opposition to) any candidate for public office. In addition, under section 501(m), an organization described in section 501(c)(3) or 501(c)(4) is exempt from tax only if no substantial part of its activities consists of providing commercial-type insurance.

A tax-exempt organization may, subject to certain limitations, enter into a joint venture or partnership with a for-profit organization without affecting its tax-exempt status. Under current ruling practice, the IRS examines the facts and circumstances of each arrangement to determine (1) whether the venture itself and the participation of the tax-exempt organization therein furthers a charitable purpose, and (2) whether the sharing of profits and losses or other aspects of the arrangement entail improper private inurement or more than incidental private benefit.[3]

### Description of Proposal

The proposal would provide that an organization shall not fail to be treated as organized and operated exclusively for a charitable purpose for purposes of Code section 501(c)(3) solely

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[2] Although not-for-profit hospitals generally are recognized as tax-exempt by virtue of being "charitable" organizations, some may also qualify for exemption as "educational organizations" because they are organized and operated primarily for medical education purposes.

[3] See IRS General Counsel Memorandum 39862; Announcement 92-83, 1992-22 I.R.B. 59 (IRS Audit Guidelines for Hospitals). Even where no prohibited private inurement exists, however, more than incidental private benefits conferred on individuals may result in the organization not being operated "exclusively" for an exempt purpose. See, e.g., <u>American Campaign Academy v. Commissioner</u>, 92 T.C. 1053 (1989).

because a hospital which is owned and operated by such organization participates in a provider-sponsored organization ("PSO") (as defined in section 1845(a)(1) of the Social Security Act), whether or not such PSO is exempt from tax. Thus, participation by a hospital in a PSO (whether taxable or tax-exempt) would be deemed to satisfy the first part of the inquiry under current IRS ruling practice.[4]

The proposal would not change present-law restrictions on private inurement and private benefit. However, the proposal would provide that any person with a material financial interest in such a PSO shall be treated as a private shareholder or individual with respect to the hospital for purposes of applying the private inurement prohibition in Code section 501(c)(3). Accordingly, the facts and circumstances of each PSO arrangement would be evaluated to determine whether the arrangement entails impermissible private inurement or more than incidental private benefit (e.g., where there is a disproportionate allocation of profits and losses to the non-exempt partners, the tax-exempt partner makes loans to the joint venture that are commercially unreasonable, the tax-exempt partner provides property or services to the joint venture at less than fair market value, or a non-exempt partner receives more than reasonable compensation for the sale of property or services to the joint venture).

The proposal would not change present-law restrictions on lobbying and political activities. In addition, the restrictions of Code section 501(m) on the provision of commercial-type insurance would continue to apply.

**Effective Date**

The proposal would be effective on the date of enactment.

[4] The qualification of a hospital as a tax-exempt charitable organization under section 501(c)(3) would be determined as under present law. See Rev. Rul. 69-545, 1969-2 C.B. 117.

## 2. Description of Taxation of MedicarePlus Medical Savings Accounts

### Present Law

Under present law, the value of Medicare coverage and benefits is not includible in taxable income.

Individuals who itemize deductions may deduct amounts paid during the taxable year (if not reimbursed by insurance or otherwise) for medical expenses of the taxpayer and the taxpayer's spouse and dependents, to the extent that the total of such expenses exceeds 7.5 percent of the taxpayer's adjusted gross income ("AGI"). Medical expenses for this purpose include amounts paid for medical insurance, including Medicare part B premiums paid by the taxpayer.

Within limits, contributions to a medical savings account ("MSA") are deductible in determining AGI if made by an eligible individual and are excludable from gross income and wages for employment tax purposes if made by the employer of an eligible individual. Earnings on amounts in an MSA are not currently includible in income. Distributions from an MSA for medical expenses of the MSA account holder and his or her spouse or dependents are not includible in income. In addition, distributions not used for medical expenses are subject to an additional 15-percent tax unless the distribution is made after age 65, death, or disability. Individuals enrolled in Medicare are not eligible to have an MSA.

Under present law, there are no specific tax provisions for MedicarePlus medical savings accounts ("MedicarePlus MSAs").

### Description of Proposal

#### In general

Under the proposal, individuals who are eligible for Medicare would be permitted to choose either the traditional Medicare program or a MedicarePlus MSA plan. To the extent an individual chooses such a plan, the Secretary of Health and Human Services would make a specified contribution directly into a MedicarePlus MSA designated by such individual. Only contributions by the Secretary of Health and Human Services could be made to a MedicarePlus MSA and such contributions would not be included in the taxable income of the MedicarePlus MSA holder. Income earned on amounts held in a MedicarePlus MSA would not be currently includible in taxable income. Withdrawals from a MedicarePlus MSA would be excludable from taxable income if used for the qualified medical expenses of the MedicarePlus MSA holder.

#### Definition of MedicarePlus MSAs

In general, a MedicarePlus MSA would be a tax-exempt trust (or a custodial account) created exclusively for the purpose of paying the qualified medical expenses of the account

holder that meets requirements similar to those applicable to individual retirement arrangements ("IRAs").[5] The trustee of a MedicarePlus MSA could be a bank, insurance company, or other person that demonstrates to the satisfaction of the Secretary of the Treasury that the manner in which such person would administer the trust would be consistent with applicable requirements.

A MedicarePlus MSA trustee would be required to make such reports as may be required by the Secretary of the Treasury. A $50 penalty would be imposed for each failure to file without reasonable cause.

**Taxation of distributions from a MedicarePlus MSA**

Distributions from a MedicarePlus MSA that are used to pay the qualified medical expenses of the account holder would be excludable from taxable income regardless of whether the account holder is enrolled in the MedicarePlus MSA plan at the time of the distribution.[6] Qualified medical expenses generally would be defined as under the rules relating to the itemized deduction for medical expenses (sec. 213). However, for this purpose, qualified medical expenses would not include any insurance premiums other than premiums for long-term care insurance, continuation insurance (so-called "COBRA coverage"), or premium for coverage while an individual is receiving unemployment compensation. Distributions from a MedicarePlus MSA that are excludable from gross income under the proposal could not be taken into account for purposes of the itemized deduction for medical expenses.

Distributions for purposes other than qualified medical expenses would be includible in taxable income. An additional tax of 50 percent of the amount includible in taxable income would apply to the extent the total distributions for purposes other than qualified medical expenses in a taxable year exceed the amount by which the value of the MedicarePlus MSA as of December 31, of the preceding taxable year exceeds 60 percent of the deductible of the plan under which the individual is covered. The additional tax would not apply to distributions on account of the disability or death of the account holder.

Direct trustee-to-trustee transfers could be made from one MedicarePlus MSA to another MedicarePlus MSA without income inclusion.

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[5] For example, no MedicarePlus MSA assets could be invested in life insurance contracts, MedicarePlus MSA assets could not be commingled with other property except in a common trust fund or common investment fund, and an account holder's interest in a MedicarePlus MSA would be nonforfeitable. In addition, if an account holder engages in a prohibited transaction with respect to a MedicarePlus MSA or pledges assets in a MedicarePlus MSA, rules similar to those for IRAs would apply, and any amounts treated as distributed to the account holder under such rules would be treated as not used for qualified medical expenses.

[6] Under the proposal, medical expenses of the account holder's spouse or dependents would not be treated as qualified medical expenses.

The proposal includes a correction mechanism so that if contributions for a year are erroneously made by the Secretary of Health and Human Services, such erroneous contributions could be returned to the Secretary of Health and Human Services (along with any attributable earnings) from the MedicarePlus MSA without tax consequence to the account holder.

**Treatment of MedicarePlus MSA at death**

The proposal includes rules that would apply on the death of the MedicarePlus MSA owner. If the beneficiary of the MedicarePlus MSA is the account holder's surviving spouse and the spouse is eligible for Medicare, the spouse could treat the inherited MedicarePlus MSA as his or her own MedicarePlus MSA. If the spouse is not eligible for Medicare, the spouse could continue the MedicarePlus MSA and make withdrawals from the MedicarePlus MSA under the rules applicable to an MSA for individuals not eligible for Medicare. Thus, earnings on the account balance would not be currently includible in income. Distributions from the account for the qualified medical expenses of the spouse or the spouse's dependents (or subsequent spouse) would not be includible in income. Distributions not for such medical expenses would be includible in income, and would be subject to a 15-percent excise tax unless the distribution is made after the surviving spouse attains age 65, dies, or becomes disabled. No new contributions could be made to the account and earnings would not be currently includible in income.

If the beneficiary of an inherited MedicarePlus MSA is not the account holder's spouse, the MedicarePlus MSA would no longer be treated as a MedicarePlus MSA and the value of the MedicarePlus MSA on the account holder's date of death would be included in the taxable income of the beneficiary for the taxable year in which the death occurred. If the account holder fails to name a beneficiary, the value of the MedicarePlus MSA on the account holder's date of death would be included in the taxable income of the account holder's final income tax return. In all cases, the value of the MedicarePlus MSA would not be included in the account holder's gross estate for estate tax purposes.

**Effective Date**

The proposal would be effective with respect to taxable years beginning after December 31, 1998.

## 3. Disclosure of Tax Return Information for Verification of Employment Status of Medicare Beneficiaries and the Spouse of a Medicare Beneficiary

### Present Law

The Internal Revenue Code prohibits disclosure of tax returns and return information, except to the extent specifically authorized by the Internal Revenue Code (sec. 6103). Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431). No tax information may be furnished by the Internal Revenue Service ("IRS") to another agency unless the other agency establishes procedures satisfactory to the IRS for safeguarding the tax information it receives (sec. 6103(p)).

Among the disclosures permitted under the Code is disclosure of taxpayer filing status and identity information for the purpose of verifying the employment status of Medicare beneficiaries and the spouse of a Medicare beneficiary.

The Medicare disclosure provision is generally scheduled to expire after September 30, 1998.

### Description of Proposal

The proposal would permanently extend the Medicare disclosure provision.

### Effective Date

The proposal would be effective on the date of enactment.