



Health Care Reform and Small Business

Jane G. Gravelle

Senior Specialist in Economic Policy

July 5, 2013

Congressional Research Service

7-5700

www.crs.gov

R40775

CRS Report for Congress

Prepared for Members and Committees of Congress

Summary

An issue in the development of the new health care reform legislation is the effect on small business. One concern is the effect of a “pay or play” provision to require firms to provide health insurance for their employees or pay a penalty. Current proposals have exemptions for small businesses, and also propose to provide subsidies for purchasing insurance. Economic theory suggests that health insurance costs (and any penalties) should be passed on to labor income, but that may be more difficult for employers of lower-wage workers.

Small businesses may benefit from the ability to purchase insurance in the exchanges set up by the states or the federal government.

On June 4, 2013, the Department of Health and Human Services announced a delay in the requirement of the plans for small businesses until 2015. On July 2, 2013, the administration announced a delay in the effective date of the employer penalty from 2014 to 2015, to allow additional time to deal with administrative issues.

Both the House bill (H.R. 3962, passed on November 14, 2009) and the Senate bill (H.R. 3590, passed on December 24, 2009) exempted small businesses from penalties. The House bill would have applied no penalties to firms with \$500,000 or less in payroll; the Senate bill exempted firms with fewer than 50 employees; the final bill followed the Senate approach. The final legislation, P.L. 111-148 and P.L. 111-152, would exempt around 95% of firms with employees, and the share of firms with employees that would not be affected either because they are exempt or because they already offer insurance would be larger, probably around 98%. About 20% of employees work for firms that were estimated to be affected. The approximately 3% of firms with employees that are subject to the penalty would have to ensure conformance with insurance requirements.

The penalty for being a large firm and not providing insurance (triggered if one or more employees are eligible for the premium credit for lower-income families) is \$2,000 per full-time employee (imposed ratably per month), but the first 30 employees are exempt. Firms that offer insurance also will pay penalties if their employees enroll in individual plans and receive the premium credit, but only for those employees. The proposals also provide temporary credits to subsidize small employers’ contributions to insurance for lower-income employees that depend on firm size and employee compensation. The credits would be as much as 50% of the employer’s cost. The subsidy for taxable firms is provided as a nonrefundable income tax credit and would not benefit firms with no income tax liability; there is a separate 35% credit for nonprofits.

The original Senate proposal had increased Medicare taxes on earned income on married couples with incomes over \$250,000 and singles with incomes over \$200,000 by 0.9 percentage points. The final legislation imposed the Medicare tax on high-income individuals’ passive investment income at 3.8%. Some concerns had been raised earlier about the effect on small business of a high-income surcharge in the House bill, which would have imposed (for couples) a 5.4% surcharge on incomes over \$1 million (\$500,000 for singles). The surcharge would have affected 0.3% of taxpayers and 1.2% of unincorporated businesses. The Medicare tax on investment affects a larger total share of the population (2.6%) but is imposed at a smaller rate. The 3.8% increase is not likely to fall on small business owners whose capital is invested in their business because this income is either already subject to Medicare or is exempt.

Contents

Introduction.....	1
The Rationale for Encouraging Employer Health Insurance	2
Overview of Provisions Relating to Small Business Adopted in P.L. 111-148 and P.L. 111-152	3
Penalty Structure.....	4
Small Business Credit.....	4
Original House Proposals Relating to Small Business	5
Original Senate Proposals Relating to Small Business.....	6
Final Legislation and the Reconciliation Bill (H.R. 4872); P.L. 111-148 and P.L. 111-152.....	7
Potential Impact of Special Provisions on Small Business.....	7
The Penalty and Exemptions	7
Effect of Penalties.....	9
Credits for Smaller Firms	12
Benefits of Community Rating.....	12
Potential Revisions to Address Criticisms of the Employer Penalty	13
Taxes on Incomes of High-Income Individuals	14
House Surtax	14
Medicare Taxes on High Income Taxpayers.....	16

Tables

Table 1. Provisions of H.R. 3962 in 2013.....	5
Table 2. Characteristics of Firms in the United States, 2006.....	8
Table 3. Health Coverage by Employer Size, 2008.....	9
Table 4. Average Earnings Per Employee by Firm Size, 2006	10

Contacts

Author Contact Information.....	17
---------------------------------	----

Introduction

One issue that has been of interest in the development of the new health care reform legislation is the effect on small business. An important feature of the plans is a “pay or play” penalty to require firms to provide health insurance for their full-time employees or pay a penalty. Given the structure of individual insurance markets, the comprehensiveness of a penalty to encourage all individuals to purchase health insurance is important to the success of the reform of health insurance markets. Employer penalties are also included in the proposals, in part to encourage the retention of existing employer plans. There is a concern that penalties will be damaging to small businesses.

The legislation considered in both the House and Senate included exemptions for small businesses, and credits to assist in providing health insurance, but these provisions differed.¹ These provisions had consequences both for small businesses and for the reforms of the individual health insurance market. Another issue that received attention in the House legislation was the effect of using a surtax on high-income individuals as a financing option; it was replaced in the final legislation with a different type of tax.

On March 22, 2010, the House passed the Senate bill (H.R. 3590) and the President signed it on March 23. The House also passed a separate bill that modifies the revenue sources and penalties, H.R. 4872. This legislation ultimately became P.L. 111-148 and P.L. 111-152, and is also referred to as the Affordable Care Act.

The penalty was scheduled to go into effect in 2014, the same time as the individual penalty for not purchasing health insurance. On July 2, 2013, the Administration announced a delay in implementation of the employer penalty until 2015, citing the need to simplify administrative complexities for businesses and give businesses more time to comply with an appropriate plan.² In addition, the Department of Health and Human Services announced a delay in the requirement to provide an exchange for small businesses, another potential reason for delaying the penalty.³

Critics of health reform have argued that the employer penalty not only causes administrative burdens but distorts firms’ choices of employees around the 50 employee level (where hiring an additional worker could trigger penalties for that employee and up to 19 additional employees)⁴ and encourages firms to reduce the hours of workers to reduce the number of full-time employees on which the penalty is based. Delaying the imposition of penalties may increase the cost of health care as would changes to liberalize it.

This report considers issues in the employer penalty for small business. It first provides a brief discussion of the need for penalties in comprehensive health care reform and why employer penalties might be useful. It also describes the provisions in the various proposals, beginning with an overview of the proposal adopted, but also discussing approaches considered during the

¹ For an overall discussion of these proposals as well as other legislative proposals, see CRS Report R40581, *Health Reform and the 111th Congress*, by Hinda Chaikind.

² See Valerie Jarrett, “We’re Listening to Businesses About the Health Care Law,” White House Blog, July 2, 2013, at <http://www.whitehouse.gov/blog/2013/07/02/we-re-listening-businesses-about-health-care-law>.

³ See CRS Report R42663, *Health Insurance Exchanges Under the Patient Protection and Affordable Care Act (ACA)*, by Bernadette Fernandez and Annie L. Mach.

⁴ This type of provision is often referred to as a cliff.

legislative development. The next section discusses the potential impact of employer penalties and credits on small business, including some of the issues raised subsequent to the legislation and options to address them. The final section discusses the effect of proposed taxes on high-income individuals.

The analysis in this report indicates that only about 2% of firms with employees would be affected by the penalty, and about 20% of employees are in those firms. Most small firms would be exempted and most large firms already offer health insurance. Therefore any behavioral effects are likely to be limited. Similarly, the 2% of firms affected are larger firms with more capabilities for administrative record keeping. At the same time, a case could be made for eliminating these penalties or revising the penalty structure.

The Rationale for Encouraging Employer Health Insurance

The health insurance and health care markets have some fundamental flaws that economists frequently refer to as “market failures,” and many of the provisions in the legislative proposals were aimed at addressing these flaws and market failures.⁵ One of these problems is “adverse selection.” If individuals know more about their health status than insurance firms, then insurance costs will be too high relative to benefits for healthy individuals, who will tend not to purchase health insurance. Their lack of participation causes the price of insurance to rise further, as those now in the insurance pool are less healthy. The end result is that many individuals will not have health insurance, exposing them to risk in the case of ill health and possibly imposing a burden on society if their illnesses become serious enough to deplete their wealth and require public assistance. In addition, even if both parties are informed about health status, people who have preexisting conditions or other characteristics that make use of health care more likely (such as old age) may not have, or be able to afford, health insurance (assuming that premiums are permitted to reflect such characteristics).

The problem of adverse selection and excessive cost has been addressed among the elderly by Medicare and is significantly reduced among the working population by employer health insurance. Some states also limit variations in premium costs. Employer health insurance also provides a pooling mechanism that is unrelated to health factors and thus addresses both the adverse selection problem and the problem of being priced out of the market for those with ill health.⁶ It also tends to reduce administrative costs compared with such costs when individuals purchase coverage on their own. These pooling and administrative advantages are lessened for businesses with few employees.

Employer-provided health care benefits should, according to economic theory, offset wages so that employees as a group are still incurring the cost of insurance, but do not face the difficulties they would with non-group private insurance purchase. Employers with small pools of

⁵ These “market failures” are discussed in CRS Report RL33759, *Health Care and Markets*, by D. Andrew Austin and in CRS Report RL32237, *Health Insurance: A Primer*, by Bernadette Fernandez.

⁶ Employer health insurance also benefits from the exclusion of premium contributions by employers from wage income, which benefits any taxpayers with income tax liability. Insurance benefits are also excluded from the payroll tax although there are future benefits that partially offset the cost of the payroll tax.

individuals may experience some of the same types of problems as individuals. If there is one employee who has (or whose family has) a serious health problem, that problem can drive up the cost for the group. Aside from the problem of too small a pool for small employers, to the extent that small businesses employ lower wage or younger workers, the trade-off of cash wages for health care becomes more difficult, and cannot occur in the case of workers at or close to the minimum wage. As indicated above, the administrative costs per employee are larger in small firms; one study estimates these costs are 18% higher for small businesses.⁷ The offering of health care plans is more common in large businesses than small ones, and the participation of workers is generally larger as well.

Two crucial elements are necessary to address the problems relating to adverse selection and lack of affordability, especially for those with preexisting conditions: some form of community pooling so that individuals with health problems (including age) would not have to pay a substantially different price, and a provision to require most individuals to have health insurance. Since health insurance through employers has worked reasonably well and more than 60% of workers are already covered by their employers, a proposal that imposes penalty to encourage health care for firms might be considered desirable as well.

Small businesses were exempted from penalties in both the House and Senate proposals, although different rules were used. The exemption in the final legislation is based on the number of employees. The legislation also includes temporary credits for certain smaller businesses. Small businesses with high cost employees can benefit from the ability to purchase insurance through a program that limits the variation in premiums. The legislation also permits existing private individual insurance outside of the community-rated pools. That means that low-cost individuals (the young and healthy) who are not covered by employer plans would wish to retain their plans, thereby raising the costs for those in the community pools. However, the community pools are the only pools that would exist for new coverage and that would provide subsidies, so they are more likely to attract lower-income individuals, even if they are young and healthy and current participation in the individual market is low.

Overview of Provisions Relating to Small Business Adopted in P.L. 111-148 and P.L. 111-152

This section briefly describes the provisions as included in the law that are especially relevant to small businesses.⁸ The penalty structure and the small business credit are described. The final legislation did not include an initial House proposal for a surtax on high-income individuals, which had been an issue of concern with some. That provision did not appear in the Senate proposal and the Medicare tax on high incomes, which is a major revenue raiser, is actually less likely to affect small business income than other income (see discussion in the “Taxes on Incomes of High-Income Individuals” section).

⁷ Executive Office the President, Council of Economic Advisers, *The Economic Effects of Health Care Reform on Small Businesses and Their Employees*, July 25, 2009.

⁸ See CRS Report R41159, *Potential Employer Penalties Under the Patient Protection and Affordable Care Act (ACA)*, by Janemarie Mulvey for a more detailed explanation of the employer penalty. See CRS Report R41158, *Summary of Small Business Health Insurance Tax Credit Under the Patient Protection and Affordable Care Act (ACA)*, by Janemarie Mulvey and Hinda Chaikind for a more detailed discussion of the small business credit already in effect.

Penalty Structure

Penalties apply for larger firms that do not provide health insurance beginning in 2014. The penalty for not providing insurance is imposed on a monthly basis. Small businesses of less than 50 full-time equivalent employees or less are not subject to the penalty.⁹ Solely for purposes of determining the size, part-time employees are aggregated to full-time equivalents by dividing total monthly part-time hours by 120. Seasonal workers are not included in determining employer size if the excess employees were seasonal employees and the workforce did not exceed the limit for more than 120 days during the calendar year.

For a large employer who does not offer insurance and who has at least one employee eligible for premium tax credits or cost sharing reductions in the individual market, a penalty is imposed. The penalty is \$2,000 per full-time employee per year (not counting part-time employees), with an exclusion for the first 30 workers. Thus a firm with no more than 30 full-time workers would not pay a penalty even if part-time workers caused them to be classified as large.

Using 50 employees as the point at which the penalty applies and assuming all full-time employees, a firm with 50 employees,¹⁰ would pay an average of \$800 per employee (50-30)/50. The 50th employee would trigger a cost of \$40,000, the 51st and after \$2,000. The average per employee would rise as employee size rose: \$800 per employee for a firm with 50 employees, \$909 for 55 employees, \$1,000 for 60, \$1,200 for 75, \$1,400 for 100, \$1,880 for 500, and so forth, until the average approaches \$2,000 at a very large size.

If a large firm offers coverage but one or more of those employees receives premium credits or cost-sharing reductions, the payment is \$3,000 for each of those employees.

Small Business Credit

Small businesses with less than 25 full-time equivalent employees and/or with average wages less than \$50,000 may be eligible for a credit of 50% of the employer's payment for two years, beginning in 2014. There is a transitional credit of 35% for 2010-2013 as well. The employer must pay 50% of the health plan cost. The credit is against income tax, so small employers without tax liability will receive no current benefit and small employers with inadequate tax liability will not receive the full current benefit. Credits can be carried backward one year (except in the first year offered) and forward 20 years plus another year.

Tax exempt entities, such as charities, are eligible for a 35% credit (25% during the transition) taken against payroll taxes.

The credit is phased out both by size and average income in an additive fashion. The credit is reduced by the number of employees over 10, divided by 15; the credit is also reduced by average wages over \$25,000 divided by \$25,000. A business with 10 or fewer employees and \$25,000 or less in average wages will receive a credit of 50%. If the wages remain at \$25,000 or less but

⁹ Note that there is an inconsistency in the law as one section of the bill indicates that a large employer is one with 50 employees, while other sections discussing modifications (such as those for seasonal workers) indicate that a large employer is one where the workforce is more than 50. The first would imply a trigger between 49 and 50 employees, while the second would imply a trigger between 50 and 51 employees.

¹⁰ As noted above, the cutoff point is not clear from the legislative language.

employee size rises to 15, the credit is reduced by 33.3% (15 minus 10, all divided by 15, or 1/3) or, for a 50% credit, to 33.3%. If average wages are \$30,000 but size is 10 or less, the credit is reduced by 20% (\$30,000 minus \$25,000, all divided by \$25,000), or, for a 50% credit to 40%. If both occur, both phaseouts are added, so that a firm with 15 employees and \$30,000 in average wages both the 33.3% and the 20% apply for a reduction of 53.3%. This phaseout would reduce the 50% credit to 23.3%.

Original House Proposals Relating to Small Business

The original House bill, H.R. 3200, was considered by three committees of primary jurisdiction, and it was referred to five committees. The three committees of primary jurisdiction were Energy and Commerce, Ways and Means, and Education and Labor. The proposal provided for penalties on firms that do not provide 65% of the cost of family health insurance (72.5% for single coverage), with exemptions for small firms. A subsequent proposal, approved in the Energy and Commerce Committee, apparently intended to exempt employers with a payroll under \$500,000 from the penalties. H.R. 3200 as reported by the other committees would have exempted employers with a payroll under \$250,000. H.R. 3962, which is based on the reported versions of H.R. 3200, used the \$500,000 exemption in the Energy and Commerce version of H.R. 3200. H.R. 3962 passed the House on November 14, 2009.

Table 1 shows the penalties for firms that do not offer insurance based on a \$500,000 level exemption. It also shows the subsidy rate in 2013 for aiding low-wage employees in small businesses, in the form of a general business credit allowed through the income tax. The credit was not available to employers without income tax liability, and the full credit may not be available to employers with small liabilities. The credit was based on the employer’s payment toward insurance coverage. The credit was not allowed to firms for employees with compensation over \$80,000, but all dollar amounts are indexed for inflation. Small businesses could purchase insurance through the exchange, which disallowed variations in premiums based on health status. It was allowed for two years.

Table 1. Provisions of H.R. 3962 in 2013

Employer Penalty or Credit	Provision
Pay or Play Penalty Payroll Level	Percentage of Payroll
\$500,000 or less	0%
\$500,000 to \$585,000	2%
\$585,000 to \$670,000	4%
\$670,000 to \$750,000	6%
Over \$750,000	8%
Subsidy for Low Wage Employees	Rate and Phaseout
10 or Fewer Employees	50% for Employer Contribution, for Compensation Less than \$20,000
Compensation Phaseout	Between \$20,000 and \$40,000
Firm Size Phaseout	Between 10 and 25 Employees

Source: H.R. 3962.

Original Senate Proposals Relating to Small Business

Senate health care proposals were originally reported by two committees of primary jurisdiction: the Senate Health, Education, Labor, and Pensions (HELP) Committee (S. 1679) and the Senate Finance Committee (S. 1796). The final Senate bill, H.R. 3590, adopted elements from both proposals. It exempted businesses with 50 or fewer employees from the penalty as in S. 1796 (S. 1679 used a 25-employee cut off). H.R. 3590 was adopted by the House and signed by the President, but the penalty structure was modified by the reconciliation proposal, H.R. 4872, which is discussed below.

H.R. 3590 adopted a flat \$750 penalty (as in S. 1679) for firms with over 50 full-time employees who do not offer insurance, and have at least one employee that receives a premium credit. (This penalty level, taken from S. 1679, was larger than the penalty in S. 1796.¹¹) The premium credit to employees was available if the employer does not provide 60% of the cost, and applied to individuals between 100% and 400% of poverty. It limited payments for health insurances to shares of income ranging from 2% to 9.8%.¹² Firms that offer insurance but have employees who receive the credit would have had to pay a penalty of \$3,000 for each affected employee, but capped in the aggregate at the amount for firms that do not offer coverage. Firms with over 200 employees that offer coverage were required to have automatic enrollment in their plans, and firms with over 50 employees are assessed a penalty of \$600 for any employee in a 60-day or longer waiting period.¹³

The subsidy for small business in H.R. 3590 was similar to that in S. 1796, and the subsidy structure was the same as the House provisions shown in **Table 1**, except that the subsidy was phased out between \$25,000 and \$50,000. It was allowed for firms that pay at least 50% of the health insurance premium. H.R. 3590 begins the credit in 2010; beginning in 2014 the phaseout amounts are indexed for inflation. The bill also allowed a credit against payroll taxes for tax-exempt organizations, at a 35% rate.¹⁴

¹¹ In the Senate Finance bill, the penalty was triggered if firms pay less than 65% of insurance costs, and the firm would pay the lesser of the premium credit or \$400 per employee. Penalties do not apply to part-time workers at \$375 as they would have under the HELP bill.

¹² CRS Report R40935, *Health Insurance Premium Credits in Senate-Passed H.R. 3590*, by Chris L. Peterson and Thomas Gabe explains the credits.

¹³ In the Senate Finance bill, S. 1796, firms with more than 50 employees would have had to pay 65% of insurance or would have to reimburse the government for any low-to-moderate income individuals who obtain premium and cost-sharing subsidies, up to a *maximum* of \$400 per employee for all employees (whether eligible for a personal credit or not), whereas H.R. 3590 imposes the per-employee penalty as long as one employee receives a subsidy. A penalty similar to the Finance Committee bill would have applied in cases where coverage is offered; however, H.R. 3590 did not include a \$375 penalty for part time workers.

¹⁴ In S. 1679, businesses with 50 or fewer workers whose average wage was less than \$50,000 would have received assistance in the form of credits if they provided at least 60% of health insurance costs. These credits, for each employee plan, are \$1,000 for self-only plans, \$1,500 for two adults or an adult and child plan, and \$2,000 for a family plan. There would have been an increase of \$100, \$300, and \$400, respectively, for each payment of 10% of the cost, in excess of the 60%, by the employer. The payments would have been allowed in full for firms with 10 or fewer employees, and reduced to 80% of these amounts for those with 11 to 20 employees, 50% for 21 to 30, 40% for 31 to 40, and 20% for 41 to 50. Self-employed individuals would have been eligible as well. The credits would be indexed to wage inflation, but allowed for no more than three consecutive years. (Note that there are delays in the effective dates).

Final Legislation and the Reconciliation Bill (H.R. 4872); P.L. 111-148 and P.L. 111-152

The final legislation adopted the Senate proposal, but with changes in a reconciliation bill. The reconciliation measure modifies the Senate penalty structure by changing the dollar amount to \$2,000 but exempting the first 30 employees. This change would lead to a slightly larger payment per employee, which rises from \$854 per employee for a firm with 51 employees and rises to approximately \$2,000 per employee. Firms that do offer coverage would have their caps affected by the change. It also counted part-time workers.

Potential Impact of Special Provisions on Small Business

Small businesses could be affected by the penalties under the pay or play rules, by credits for purchase of insurance, and by the community rating aspects of the proposal. The analysis below was prepared during consideration of the health legislation, but the results are unlikely to change with updated data.

The Penalty and Exemptions

The number of small businesses potentially affected by the penalty for health insurance depends both on the distribution of firms and the number that already offer insurance.

Small businesses are quite concentrated as micro-businesses with very few employees. As shown in **Table 2**, 61% of firms in the United States have four or fewer employees and almost 80% have less than 10 employees. (These data do not include self-employed individuals with no employees who account for the vast majority of small businesses.) The term small business will refer to small businesses with employees.

The Senate and House proposals differed on what characteristics determine the exemption: the Senate proposal was based on number of employees and the House proposal was based on size of payroll. In general, the Senate proposal was likely to be more generous because 25 employees would exceed a \$500,000 payroll at \$10,000 per employee, a lower-than-average wage.

For the original Senate HELP Committee proposal which exempted firms with 25 employees, all of the first three classes in **Table 2**, which amounts to 89.3% of all businesses, as well as a part of the fourth class, would have been exempt from the penalty. Thus, more than 90% of firms would be excluded from any penalty. The first three classes account for 18% of employees in the United States; thus, approximately one-fifth of employees would not be covered by the penalty. The Senate Finance Committee and H.R. 3590 have a 50-employee cut off. This proposal was adopted. While it is difficult to interpolate the numbers in **Table 2**, it appears that about 95% of businesses would fall under this exemption and over a quarter of employees.

Table 2. Characteristics of Firms in the United States, 2006

Number of Employees in Firm	Percentage of Firms	Average Payroll (\$)	Percentage of Work Force
0-4	60.9	62,596	5.0
5-9	17.6	201,866	5.8
10-19	10.7	436,866	7.2
20-99	8.9	1,384,522	18.0
100-499	1.5	7,297,315	14.6
500 and Over	0.3	147,398,418	49.5

Source: U.S. Census, Statistics of U.S. Businesses, <http://www.census.gov/econ/susb/>.

For the House proposal with a \$500,000 wage level, the exemption could only be approximate, because there would be variations in payroll.¹⁵ However, based on the average payroll per firm reported in **Table 2**, it appears that the first two classes and probably at least three-quarters of the third would likely be excluded under a \$500,000 exemption, accounting for 86%-87% of firms. This number was consistent with news reports that indicate the \$500,000 amount would exempt 86% of firms.¹⁶ About 16% of employees would be exempt.¹⁷ However, without adjustments for inflation and real income growth, the share of firms excluded with a dollar limit would be smaller on enactment and decline over time. For example, with a 4% annual nominal growth rate, by 2013, when the program had taken effect, the \$500,000 value would be equivalent to \$380,000, with closer to a quarter of the third category excluded, and with the overall share of firms excluded closer to 81%-82%. Thus, by adopting the Senate exemption of 50 employees, the effects on small business are lessened.

There are advantages and disadvantages to the alternative exemption approaches, which could be based on number of employees or size of payroll. An exemption based on number of employees is not likely to reduce the share of businesses exempt over time, although a dollar exemption indexed to wage growth would also keep the share relatively stable over time. The exemption based on payroll was relatively more beneficial to small firms with lower-wage employees, where the personal assumption of the cost may be more difficult.

The share of firms that would not be affected because they are either exempt from the penalty or are already providing health insurance would be larger than the share exempt from the penalty alone. **Table 3** shows estimates of the share of employees in firms with health insurance coverage, although the data are for 2002, the most recently available at the time of the legislative

¹⁵ The percentages in this paragraph were estimated assuming the average wage is the midpoint of the distribution, which provides only an approximation.

¹⁶ See, for example, Heather Rothman, et al. *Tax Changes Expected as Part of House Deal on Health Care Reform*, Bureau of National Affairs, July 30, 2009, http://www.bnasoftware.com/News_Articles/News/Tax_Changes_Expected_as_Part_of_House_Deal_on_Health_Care_Reform.asp.

¹⁷ Under the earlier version with the \$250,000 exemption, most of the first two classes (about 78% of firms) would be excluded. About 10% of employees would be excluded. The Executive Office the President, Council of Economic Advisers, *The Economic Effects of Health Care Reform on Small Businesses and Their Employees*, July 25, 2009, cited above, reports that 77% of businesses would be excluded with a less than \$250,000 payroll benchmark criterion and that 87% would be excluded with a less than \$500,000 payroll. These numbers sort by establishment size rather than firm size. The Medical Expenditure Panel Survey also provides data by establishment. See http://www.meps.ahrq.gov/mepsweb/data_stats/summ_tables/insr/national/series_1/2008/tia1.pdf.

development. It is not likely to have changed significantly. It shows the percentage of employees actually covered (employees may decline coverage because they do not wish to pay their own share of the costs or because they are covered under another family member's insurance). **Table 3** also shows the average cost of coverage per covered employee for a family plan. These costs are similar and do not show a specific trend (the cost is larger for very small firms because employers pay about 80% of the cost; in other firm sizes average shares are between 65% and 75%).

Table 3. Health Coverage by Employer Size, 2008

Number of Employees in Firm	Percentage of Employees in Firms Offering Coverage	Percentage of Employees Eligible	Percentage of Employees Covered	Cost Per Employee Covered (\$) Family Plan
Under 10	45.0	37.8	29.8	9,310
10-24	69.5	54.4	40.4	8,195
25-99	85.3	64.9	48.0	7,447
100-999	95.9	72.3	57.7	8,602
1000 and Over	99.0	79.4	63.1	9,370
All	87.7	68.4	53.9	8,904

Source: Medical Expenditure Panel Survey, <http://www.meps.ahrq.gov/mepsweb/SBAHQ03M0562>, <http://www.sba.gov/advo/research/rs262tot.pdf>.

For the Senate HELP Committee proposal, data in **Table 3** are used to estimate that roughly another 7% of firms may be firms that are not eligible for the exemption, but already are providing coverage.¹⁸ Thus about 97% of firms would not be required to offer coverage that they had not already offered.¹⁹ This leaves only 3% of firms, mostly those with between 25 and 100 employees, who would be required to offer insurance or pay a penalty. An even smaller percentage of firms would be affected under the Senate Finance Committee plan and H.R. 3590, probably less than 2%. For the House proposal with a \$500,000 limit, another 8.6% of firms are not eligible for the exception but are already providing health insurance; thus, more than 95% of firms would not be required to offer coverage that they have not already offered, leaving 4% to 5% of firms affected. This share would fall slightly due to the lack of indexing.

Effect of Penalties

If firms affected do not offer insurance, they are subject to a penalty in certain circumstances. In the Senate bill, H.R. 3590, which was likely to be somewhat less burdensome for firms, the penalty was \$750 for each full-time employee if one employee received a premium credit. It did not apply to firms with 50 or fewer employees. (The Senate Finance Committee plan, where firms with 50 or more employees who do not offer health insurance would have to reimburse the

¹⁸ The 7% is based on 8.9% times 0.642 plus 1.5% times 0.723 plus 0.3% times 0.794. Note, however, that this is a rough estimate because the data reflect the percentage of employees and not the percentage of firms. In general, because of the rising coverage, the share of employees would be larger than the share of firms. However, if the average for the next lower category were used instead, which would likely be an understatement, the share would be 6%.

¹⁹ The total of 97% is the sum of the 90% not subject to the penalty and 7% subject to the penalty but already offering insurance.

government for any low-to-moderate income individuals who obtain premium and cost-sharing subsidies, up to a maximum of \$400 per employee for all employees, would have been even less onerous.) Based on the maximum, the penalties appear to be smaller than in the other proposals.

The House proposal applied the penalty as a percentage of payroll, so the penalty would have been less for firms whose employees earn less. **Table 4** shows the average wage by employer size. Note that the average wages for the smallest firms are actually higher than those for mid-sized firms (but not for the very large firms). As noted in **Table 2**, the penalty as a percentage of income rises by payroll size and can be imposed at a 2%, 4%, 6%, or 8% rate. Given earnings of around \$35,000 for the smallest non-exempt category, these rules amount to penalties per employee of \$700 (2% of \$35,000) for the smallest firm category of \$500,000 to \$585,000. For the larger percentages (4%, 6%, and 8%) the amounts would be \$1,400, \$2,100, and \$2,800. The penalties in the House proposal appear, therefore, to be greater in most cases than those in the Senate proposal.

Table 4. Average Earnings Per Employee by Firm Size, 2006

Number of Employees in Firm	Average Earnings Per Employee (\$)
0-4	38,547
5-9	30,707
10-19	32,524
20-99	35,200
100-499	37,680
500 and Over	44,612

Source: U.S. Census, Statistics of U.S. Businesses, <http://www.census.gov/econ/susb>.

The reconciliation proposal provided effects that, like the House proposal, would rise with the firm size, although the penalties would apply to fewer firms because more firms are exempt (and those in the smallest percentage category in the House bill would likely be exempt under the Senate bill). For example, a firm with 51 employees would pay an average penalty of \$824, a firm with 75 employees would pay an average of \$1200, a firm with 100 employees would pay an average of \$1,400, and a firm with 500 employees would pay an average of \$1,880. Thus, the reconciliation penalty amounts are larger than the original Senate bill but smaller than in the House bill.

In theory, penalties should help induce firms that fall under the penalty (i.e., are not exempted from penalties by size) and are not currently providing health insurance to do so. Although only about 3% of firms in the Senate proposal and about 4%-5% in the House proposal with a \$500,000 exemption fall into this group, they are larger firms that employ a larger fraction of the work force. The share of employees falling into this category was about 22% of the workforce for the Senate HELP plan and the House plan with the \$500,000 exemption; it was somewhat less for the Senate bill, H.R. 3590.

The penalty in the Senate bill was relatively small compared with the cost of insurance. According to the National Center for Health Care Reform, the premium in 2008 for a family of four was \$12,700, with the individual paying \$3,400, leaving the employer with a cost of

\$9,300.²⁰ The average cost for a single person was \$4,700. Under the House bill, the employer must pay at least 65%, or over \$8,000, for a family of four (under the Senate bill, the share is slightly smaller, 60%). These costs would be expected to be higher when the proposal was implemented. Note also that contributions employers make toward coverage would only be based on those who enroll.

Economic theory suggests the penalty should ultimately be passed through to lower wages and would not be a burden on small business owners. If firms cannot pass on the cost in lower wages, the higher cost of workers may lead firms to reduce output and the number of workers. (Individuals with lower incomes, however, should be able to receive subsidies in the community-rated pools, which will increase their welfare.) For the firm, paying a penalty may be more feasible than providing insurance, especially if their employees are lower income and the wage cannot be lowered below the minimum wage or the burden is too great.

The exemption approach in the Senate bills proposes a flat penalty per employee for firms with more than a specific number of employees and with at least one employee receiving a premium credit. The House proposal phases in the penalty amount by discrete firm size. The reconciliation proposal also provides for an increase in the penalty as firm size increases.

Any exemption based on size can create disincentives for adding employees. When there is a flat rule that imposes the full penalty at a specific level (often referred to as a cliff), an additional employee or dollar of payroll at that point will trigger a significant cost and discourage expansion. By phasing in the penalty as employee size or payroll rises, the cost will rise more smoothly and the disincentive at any specific point will be smaller.

For example, for the Senate bill, assuming full-time employees, the addition of the 51st employee would cost \$38,500 (\$750 times 51) in penalties, and each employee after that one would trigger an additional cost of \$750. With a 25-employee cut off, the addition of the 26th employee would have been \$19,500 (26 times \$750). An initial proposal in the HELP Committee plan would have exempted the first 25 employees; the additional penalty cost of an employee after the first 25 employees is \$750 per employee. Similarly, if the firm has no employees that trigger the premium credit and are above the limit, hiring a lower-income employee would trigger a large cost.

The House proposal had a phase-in, although it was not smoothly imposed and results in smaller cliffs. Without a phase-in, the first dollar in payroll after \$500,000 would result in a penalty of \$40,000.08 (0.08 times \$500,001). With the discrete phase-in, the first dollar in payroll after \$500,000 would trigger the 2% penalty on all payroll, \$10,000.02 (\$500,001 times 0.02). Every dollar after that point would trigger an additional \$0.02, until the firm reaches \$586,000, when the increase in the penalty to 4% would be triggered. At that point the penalty would rise by \$11,704 (\$585,000 times 0.02 plus \$0.04). Penalties of this general magnitude would be triggered at each discrete point when the percentage rises.

The reconciliation proposal (H.R. 4872) means that the 51st employee would trigger a payment of \$2,000 times 21 (because the first 30 employees are exempt), or \$42,000. Thereafter, each employee will add an additional \$2,000.

²⁰ See <http://www.nhc.org/facts/cost.shtml>.

Another approach would be to phase in the penalty over some level of employees or income. For example, to phase in the House penalty smoothly between \$500,000 and \$1 million, the \$500,000 exemption would be reduced for each dollar over \$500,000. For a firm with a \$600,000 payroll, the exemption would be \$400,000 (\$500,000 minus the amount of payroll over \$500,000). Over the phase-in range, the cost of adding a dollar of payroll would be \$0.16 per dollar (the dollar would result in its own penalty of \$0.08 and the phase-in would add another \$0.08) until the phase-in was complete. The penalty after the phase-in is \$0.08 per dollar. A similar phase-in could be applied to a plan based on employee size, as in the Senate proposals.

Credits for Smaller Firms

Under the original Senate HELP proposal, a credit would have been offered through a government program, whereas in the House, Senate Finance Committee, and final Senate bills, credits would be an income tax credit. Under the income tax credit, firms' credits would be limited to income tax due, which could be smaller than the allowed subsidy, and firms without profit and tax liability would not receive a benefit (although there would be carryovers and carrybacks). A special provision in the Senate Finance Committee plan and the Senate bill (H.R. 3590) would allow a subsidy (at a lower rate) for small tax-exempt charitable organizations (but limited to payroll taxes).

The credits are intended to encourage coverage and are targeted at the firms not subject to penalties (as discussed above). For very small firms and very low-income workers, the subsidy is significant, but it declines as incomes and firm size rise. Where it applies, the full subsidy was larger in the House bill, the Senate Finance plan, and the Senate bill (H.R. 3590) than in the Senate HELP plan given the general cost of insurance. For example, if the insurance cost for a single worker is \$4,700, then 72.5% of the cost is about \$3,400, and 50% of that cost would be \$1,700, covered by the subsidy in the House bill. For the Senate Finance Committee and final Senate proposals, if 50% is paid by the employer, the subsidy is \$1,175. The House, Senate Finance Committee, and final Senate (H.R. 3590) subsidies were phased out quickly as average wages rise, however; so in that respect the Senate HELP plan is more generous. The final Senate bill (H.R. 3590) was more generous than the House and Senate Finance Committee plans, as the phaseout occurred between \$25,000 and \$50,000 in average wages rather than \$20,000 and \$40,000. In both plans almost all exempt businesses would be eligible for the full subsidy because they have 20 or fewer employees. Without more data on the dispersion of wages within the firms it is not possible to estimate how many employees would be in firms eligible for the employer credit. The House, Senate Finance Committee, and final Senate bill (H.R. 3590) subsidies are phased out smoothly without any cliffs; the Senate HELP proposal has cliffs (see discussion of cliffs in the previous section) based on firm size.

Benefits of Community Rating

For some small firms, the ability to buy insurance through the insurance pool that restricts variation in premiums, including disallowing charges for preexisting conditions and limiting differences by age, will be a significant benefit. State exchanges will be required to offer small business plans for firms with 100 or fewer employees (although they have the option to limit the plans to firms with 50 or fewer employees until 2016). This requirement has been delayed until 2015. As with individuals, very small firms that have individuals or families whose health care is more costly will be more easily able to purchase insurance. These additional costs will be spread across many other firms or individuals and will remain attractive to many healthy individuals

because of the individual subsidies. Thus, they should reduce the problem of adverse selection.²¹ Firms with healthier employees could see a rise in cost.

Potential Revisions to Address Criticisms of the Employer Penalty

Aside from concerns about the compliance and administration, some have charged that certain aspects of the exemptions will cause undesirable incentives, such as encouraging firms to avoid hiring or to reduce employment to fall below the limit, significantly increasing the cost of hiring low wage workers, and encouraging firms to reduce the hours of employees to make them part time. As noted earlier, the circumstances in which these effects are likely to occur are limited to about 3% of firms because most firms fall well under the limit and most larger firms already have health insurance. One forecaster has observed that projected employment effects leading up to implementation have not been very large, which may reflect the limited effect of the penalty.²²

Nevertheless, some revisions might reduce or moderate these issues. One could also make an argument that an employer penalty is not needed with the reforms for individual insurance. Note that options to liberalize exemptions will increase costs, however. The penalties are expected to raise about \$5 billion in FY2015, and liberalizing the rules would add to the cost of health reform by reducing revenue from the penalties. In addition, if the exemption caused firms to forego health insurance, subsidies for individual insurance would increase.

Among options that might be considered are:

- Addressing the cliff that can create large costs when hiring the 50th employee, especially for a firm with full-time workers. One way to do so would be to exempt the first 49 employees rather than the first 30.
- Allowing an alternative dollar exemption as an option. A dollar exemption as an alternative could exempt more firms with low-wage employees where it is more difficult to pass on the costs. It would need to be much higher than the exemptions in the original house proposal to matter. For example, with a \$2 million wage exemption, a firm with average wages of \$40,000 would not be affected (as the exemption level would still be 50 for that firm), but a firm with average wages of \$20,000 would have an exemption level of 100.
- Providing an increase in the limit by industry or type of employee. Certain industries, such as the restaurant or retail industry, not only have lower wage workers, but their workers may be young and already covered by their parents' or schools' health insurance or older and covered by Medicare. A targeted

²¹ These issues are discussed in Executive Office the President, Council of Economic Advisers, *The Economic Effects of Health Care Reform on Small Businesses and Their Employees*, July 25, 2009, <http://www.whitehouse.gov/assets/documents/CEA-smallbusiness-july24.pdf>.

²² See comments of Mark Zandi indicating the predicted employment effects were lower than expected and appear to be modest in Danielle Kurtzleben, "Businesses Applaud Affordable Care Act," *U.S. News and World Report*, July 3, 2013, http://news.yahoo.com/businesses-applaud-affordable-care-act-delay-135819141.html;_ylt=A2KJ2UbEatRRW3oAENDQIDMD.

liberalization with respect to these industries or employees might be considered. Industry targets, however, tend to complicate administration.

- Expanding the number of employees before the penalty applies.

It is difficult to address the incentive to move employee hours below the 30-hour cutoff of some sort that differentiates between full time and part time. Penalties could be applied to all full-time equivalents which would eliminate the incentive for firms that elect to pay the penalty, but there would need to be a cutoff for requiring health insurance.

Taxes on Incomes of High-Income Individuals

The original House proposals would have imposed a surcharge on high-income individuals, which raised some issues concerning small business, originally on incomes above \$350,000, but the final House bill imposed a tax only on incomes over \$1 million for married couples and \$500,000 for singles. H.R. 3962 would, according to the committees' summary, affect 0.3% of taxpayers.

The Senate proposal, H.R. 3950, which has been passed and signed into law, imposes a 0.9% Medicare tax on earnings of married couples over \$250,000 and singles over \$200,000.

The reconciliation proposal, H.R. 4872, imposes a 3.8% Medicare tax on the passive income of those with incomes over \$250,000 (couples) and \$200,000 (singles), limited to the excess of income over these amounts or total passive income, whichever is smaller. According to Tax Policy Center estimates, these taxes are estimated to affect 2.6% of taxpayers.²³

This section first reviews the issues raised by the House surtax. It then addresses the effects, by comparison, of the Medicare tax.

House Surtax

Particular concerns were expressed about the effect of the surtax in the House bill on small businesses, job creation and entrepreneurship. Most smaller businesses are unincorporated or treated as such by the tax system with income flowing through to the proprietor or partner and are thus subject to the individual income tax. Only about 4% of businesses would have been affected by the original surtax,²⁴ and, according to the committees' outline, only 1.2% would have been affected by the revised surtax.

A larger share of income, as opposed to taxpayers, would have been affected. For example, returns with more than \$1 million account for 15.1% of adjusted gross income, according to IRS statistics, but only 0.2% of returns. Taxpayers with income more than \$500,000 account for

²³Estimates at <http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=2679&topic2ID=60&topic3ID=73&DocTypeID=>

²⁴Data from the Joint Committee on Taxation, reported by the Ways and Means Committee in "Paying for Reform," <http://waysandmeans.house.gov/media/pdf/111/pfr3200.pdf>.

22.4% of income, but 0.7% of returns.²⁵ These statistics indicate the degree to which income is concentrated at higher-income levels.

In addition, business income is more concentrated in higher-income levels than other types of income. Overall, labor income accounts for about three-quarters of overall income, with the remainder divided almost evenly between passive capital income (interest, dividends, and capital gains), pensions, and business income. In the top 1%, labor income is less than half of income. Individuals with incomes more than \$1 million account for 33% of unincorporated business net income for businesses with positive income, and individuals with incomes more than \$500,000 account for 39%. This concentration primarily reflects partnership and Subchapter S firms rather than proprietorships.²⁶ Returns with adjusted gross income of \$1 million or more accounted for 7.5% of total proprietorship income, whereas returns with income more than \$500,000 accounted for 12.6%. For partnerships and Subchapter S firms (corporations that elect to be taxed as partnerships), returns more than \$1 million accounted for 49% of net income and returns with income more than \$500,000 accounted for 64% of net income. Supporting this finding, a 2007 Treasury study indicated that taxpayers at the top tax rate (constituting a similar share of returns to those covered by the surcharges) are responsible for 61% of business flow-through income.²⁷

Some of the income in partnership and proprietorship incomes may reflect passive income and income from tax shelters, however. According to IRS data, almost 85% of partnership income is in limited liability companies or limited partnerships. Thus, these business income shares include passive income, rather than income involved in active business, and also significant income that is in businesses that are not the new and innovative firms that are often the focus of those concerned with entrepreneurship and job creation. The Treasury study indicated that these high-income taxpayers accounted for only 46% of active, positive business income. Supporting this notion that many of these businesses are not active, the Tax Policy Center found that of the returns affected by the surtax with business income, only 22.8% had business income that was more than half of total income.²⁸ This small income share also suggests much of this income is passive investment income that, absent the current rules that permit firms to operate with limited liability but not be subject to the corporate tax, would be in the form of corporate dividends and capital gains, not active business operations.

Data suggest that while business income may be somewhat more concentrated than income overall, much of small business income is associated with passive investments, stockbrokers, lawyers, doctors, and accountants who are unlikely to be innovators or important sources of job creation for lower and moderate income individuals. Trade, construction, and most services are also unlikely to be important sources of innovation, which is an argument advanced for providing relief to small businesses. Thus, very little of the increased tax revenue is likely to be collected from the businesses that are associated with innovation, entrepreneurship, or important sources of new jobs.

²⁵ Internal Revenue Service, *Statistics of Income*, 2006.

²⁶ Unincorporated business income for tax purposes is in three forms: businesses run by a single owner (proprietorships), businesses run by partnerships (multiple owners) and Subchapter S corporations (small businesses that are incorporated but elect to be taxed as proprietorships or partnerships). See CRS Report R40748, *Business Organizational Choices: Taxation and Responses to Legislative Changes*, by Mark P. Keightley.

²⁷ Treasury Conference on Business Taxation and Global Competitiveness, July 23, 2007, <http://www.treas.gov/press/releases/reports/07230%20r.pdf>.

²⁸ Tax Policy Center, Table T09-0351, *Distribution of Tax Units with Business Income*, <http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=2426&DocTypeID=7>.

About two-thirds of partnership income reflects finance, real estate, oil and gas extraction (which includes passive partnerships), and services (such as doctors and lawyers).²⁹ About 8% of total income was from real estate and oil and gas respectively, 19% from finance and insurance (with almost 80% of that total from securities and investment firms), 15% in professional services (with about 60% of the total legal services) and 5% in health (with about half of that total for physicians and dentists).

Subchapter S firms are more broadly distributed. Subchapter S income is about 40% of the total of Subchapter S and partnership income. According to the IRS data for 2006, the single largest share of Subchapter S income is in trade (19%) followed by manufacturing (14%), construction (13%) and professional services (11%). Finance, insurance, and real estate accounts for about 9%. Most of the remaining third is in some form of services.³⁰

In addition, questions could be raised about the argument that small businesses are important as sources of new jobs. Small businesses create more jobs but also are the greatest sources of job loss. They create more net new jobs, but, according to Edmiston, this evidence is not entirely clear because of migration across size classifications; moreover, although this sector of the economy may offer more opportunities to women and minorities, it pays less, is less stable, and has fewer fringe benefits.³¹

Aside from the issue of the number and quality of jobs, standard economic theory suggests that there is no need for a permanent policy to create jobs in general. Although a stimulus aimed at creating jobs may be needed in an economic downturn and programs to improve skills of marginal workers could increase labor force participation, economic theory, again, suggests that a permanent policy directed at job creation would be unnecessary, and also inefficient if it misallocates resources. As the economy grows, it naturally creates its own jobs as evidenced by the growth in the employment over time.

If a major objection to the surtax was the effect on small businesses, income from selected types of business operations (presumably not for lawyers, doctors, or stockbrokers) could be excluded from the surcharge. Flow-through income is a larger share of income of the top 1% (about one-quarter) than of the population as a whole (about 9%).³² An exclusion of all flow-through income would sacrifice around a quarter of revenue, but the loss would be much smaller if passive income and income from finance, real estate, insurance, oil and gas extraction, and professional services were not permitted an exclusion.

Medicare Taxes on High Income Taxpayers

The concerns about the Medicare tax seem somewhat lessened in the case of small business. Although it will affect more individuals, the rate is lower. Small business owners' investments in their business, however, will be affected relatively less than other types of investment. For proprietorships and partnerships, the Medicare tax is already paid on active business investment

²⁹ Internal Revenue Service, *Statistics of Income*, 2006.

³⁰ Internal Revenue Service, *Statistics of Income*, 2006.

³¹ Kelley Edmiston, "The Role of Small and Large Businesses in Economic Development," Federal Reserve Bank Kansas City, *Economic Reviews*, 2nd Quarter, 2007, pp. 73-97.

³² CRS Report RL33285, *Tax Reform and Distributional Issues*, by Jane G. Gravelle.

income simply as a part of earnings from a trade or business, so the additional tax will be only 0.9%. Subchapter S firms can report separate amounts for wages and other income, so the Medicare tax would apply to higher wages but active income is excluded. Thus, either because it is already taxed or explicitly excluded, the 3.8% tax will not apply to active business income. (It will apply to passive income, such as dividends, interest, and capital gains other than from assets held in a trade or business, and to passive income in a business.)

Although there are no separate estimates for small business, the tax is relatively modest for most taxpayers. According to distributional data for a similar tax by the Tax Policy Center, with a 2.9% rate on investment income, the average dollar amount of tax paid in the \$200,000 to \$500,000 income class would be \$425. On average, this amount was one-tenth of 1% of income.³³ Correcting for the higher rate of 3.8%, the most this amount could be is \$557, if all the income taxed in excess of the thresholds were unearned; if half of income were unearned and half earned, it would be \$489.³⁴ In the next higher-income class of \$500,000 to \$1,000,000, the tax was \$4,162, six-tenths of 1% of income. (If adjusted for the higher tax rate, it would be \$5,453 if all taxed income were unearned and \$4,786 if half were earned).

Author Contact Information

Jane G. Gravelle
Senior Specialist in Economic Policy
jgravelle@crs.loc.gov, 7-7829

³³ Distributional data are available at <http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=2679&topic2ID=60&topic3ID=73&DocTypeID=>

³⁴ With all income subject to tax unearned, the tax would rise by 3.8/2.9, or 31%. If half were earned and half were unearned, the tax would be $0.5 \times (3.8 - 2.9) / (0.5 \times 0.9 + 0.5 \times 2.6)$ or 15%.