EMPLOYERS AND INDIVIDUALS: THE NEW TAX PROVISIONS RELATING TO HEALTH COVERAGE

Client Advisories

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The 2010 health care reform legislation contains two fundamental mandates: (i) most individuals must have qualifying health coverage or pay a penalty; and (ii) certain employers must offer and contribute to their workers' health insurance or pay a penalty.

INDIVIDUALS

The Individual Mandate: beginning in 2014, U.S. citizens and legal residents must have "minimum essential coverage". Minimum essential coverage includes employer-sponsored plans, plans in the individual market, government-sponsored programs (including Medicare, Medicaid, coverage for members of the military and veterans health care) and church plans.

Exemptions from the coverage requirement are allowed for financial hardship, religious objections, American Indians, those without coverage for less than three months during a calendar year, aliens not lawfully present in the United States, incarcerated individuals, those for whom the lowest cost plan option exceeds 8% of household income, those with incomes below the tax filing threshold (in 2010, the threshold for taxpayers under age 65 is $9,350 for singles and $18,700 for couples) and those residing outside of the United States.

Those without coverage will be subject to a penalty equal to the greater of: (a) $695 per year (one-half of that amount for individuals under age 18), up to a maximum of three times that amount ($2,085) per family, or (b) 2.5% of household income over the threshold amount of income required for income tax return filing. The penalty will be phased in as follows: $95 in 2014, $325 in 2015, and $695 in 2016 for the fixed penalty component, and 1% of taxable income in 2014, 2% of taxable income in 2015 and 2.5% of taxable income in 2016. Beginning in 2017, the penalty will be increased annually by a cost of living adjustment.

The penalty applies to any period during which the individual does not maintain minimum essential coverage. It is assessed through the provisions of the Internal Revenue Code and will be accounted for as an additional

amount of federal tax owed.

That being said, think about this: according to the Joint Committee Report (i) failure to pay the penalty carries no civil or criminal penalties; (ii) interest does not accrue on late payments; and (iii) the collection and enforcement provisions of the Tax Code do not apply to the collection of this penalty (in particular, the use of liens and seizures otherwise authorized for the collection of taxes does not apply to the collection of this penalty).

Premium Assistance Tax Credits for Purchasing Health Insurance. The centerpiece of the health care legislation is its provision of tax credits to low and middle income individuals and families for the purchase of health insurance. For tax years ending after 2013, the new law creates a tax credit (the "premium assistance credit") for eligible individuals and families who purchase health insurance through a health insurance exchange. The premium assistance credit, which is refundable and payable in advance directly to the insurer, subsidizes the purchase of health insurance coverage through an exchange.

Under this provision, an eligible individual would enroll in a plan offered through an exchange and report his or her income to the exchange. Based on the information provided to the exchange, the individual would receive a premium assistance credit (based on income), and the IRS would pay the amount of the premium assistance credit directly to the insurance plan in which the individual enrolls. The individual would then fund the difference between the amount of the premium assistance credit and the total premium charged by the plan. For employed individuals who purchase health insurance through an exchange, the premium payments would be made through payroll deductions.

The premium assistance credit will be available for individuals and families with incomes up to 400% of the federal poverty level ($43,320 for an individual or $88,200 for a family of four, using 2009 poverty level figures) who are not eligible for Medicaid, employer-sponsored insurance or other acceptable coverage. The credit will be available on a sliding scale basis. The amount of the credit will be based on the percentage of income which the cost of premiums represents, rising from 2% of income for those at 100% of the federal poverty level for the family size involved to 9.5% of income for those at 400% of the federal poverty level for the family size involved.

Limitation on Reimbursement for Over-the-Counter Medications from HSAs, FSAs, and MSAs. The new law excludes the cost of over-the-counter drugs not prescribed by a doctor from being reimbursed through a health reimbursement account ("HRA") or a health flexible savings account ("FSA") and from being reimbursed on a tax-free basis through a health savings account ("HSA") or Archer Medical Savings Account ("MSA"), effective for tax years beginning in 2011.

Increased Penalties on Nonqualified Distributions from HSAs and Archer MSAs. The new law increases the tax on distributions from an HSA or an Archer MSA which are not used for qualified medical expenses to 20% of the disbursed amount (up from 10% for HSAs and 15% for Archer MSAs), effective for distributions made after Dec. 31, 2010.

Limit FSAs to $2,500. An FSA is one of a number of tax-advantaged financial accounts that can be set up through a cafeteria plan of an employer. An FSA allows an employee to set aside a portion of his or her earnings to pay

for qualified expenses as established in the cafeteria plan, most commonly for medical expenses but often for dependent care and other qualifying expenses. Under current law, there is no limit on the amount which an employee may contribute to an FSA. Under the new law, however, allowable contributions to health FSAs will be capped at $2,500 per year, effective for tax years beginning after Dec. 31, 2012. That dollar amount will be indexed for inflation after 2013.

Dependent Coverage in Employer Health Plans. Effective immediately, the new law extends the general exclusion from taxable income for reimbursements for medical care expenses under an employer-provided accident or health plan to any child of an employee who has not attained age 27 as of the end of the tax year. This change is also intended to apply to the exclusion for employer-provided coverage under an accident or health plan for injuries or sickness for such a child. A parallel change is made for VEBAs and 401(h) accounts. Also, self-employed individuals are permitted to take a deduction for the health insurance costs of any child of the taxpayer who has not attained age 27 as of the end of the tax year.

Floor on Medical Expense Deduction Raised from 7.5% of Adjusted Gross Income ("AGI") to 10%. Under current law, taxpayers can take an itemized deduction for unreimbursed medical expenses for regular income tax purposes only to the extent those expenses exceed 7.5% of their AGI. The new law raises the floor from 7.5% to 10%, effective for tax years beginning in 2013. The floor for individuals age 65 and older (and their spouses) will remain unchanged (7.5%) through 2016.

EMPLOYERS

The Employer Mandate. effective for months beginning after December 31, 2013, if a large employer does not offer coverage for all of its full-time employees, or if it offers minimum essential coverage that is unaffordable, or if it offers minimum essential coverage that consists of a plan under which the plan's share of the total allowed cost of benefits is less than 60%, the employer will be required to pay a penalty if any full-time employee is certified to the employer as having purchased health insurance through a state health insurance exchange with respect to which a tax credit or cost-sharing reduction is allowed or paid to the employee.

Who Is Subject to the New Mandate? Answer: "applicable large employers." An applicable large employer is defined as an employer that employed an average of at least 50 full-time employees during the preceding calendar year. Businesses with fewer than 50 full-time employees are, therefore, exempt from this requirement.

In counting the number of employees, a full-time employee (meaning, for any month, an employee working an average of at least 30 hours or more each week) is counted as one employee, and all other employees are counted on a pro-rated basis.

An employer with 50 or more employees is not subject to the penalty if the employer does not have any full-time employees who are certified to the employer as having purchased health insurance through a state insurance exchange with respect to which a tax credit or cost-sharing reduction is allowed or paid to the employee. In other words, if an employer does not have any full-time employees who have a lower income that might qualify them to receive a subsidy when purchasing a health plan on a health insurance exchange, the employer will not be subject to the penalty.

Penalty for Employers Not Offering Coverage. The penalty for any month in which the employer fails to offer the required coverage is an excise tax equal to (i) the number of full-time employees in excess of a 30-employee threshold during the applicable month (regardless of how many employees receive a premium tax credit or cost-sharing reduction), multiplied by (ii) one-twelfth of $2,000. For example, if an employer has 70 full-time employees, if the employer fails to offer minimum essential coverage for an entire year, and if 10 of the 70 receive a tax credit for the year for enrolling in a state-offered exchange plan, the penalty will be $2,000 for each employee over the 30-employee threshold, for a total penalty of $80,000 for the year [$2,000, multiplied by 40 (70 minus 30)]. The penalty is assessed on a monthly basis.

Compare: Penalty for Employers that Offer Coverage, but Have At Least One Employee Receiving a Premium Tax Credit. An applicable large employer who offers coverage but has at least one full-time employee receiving a premium tax credit or cost-sharing reduction is subject to a penalty, but it's computed differently. The penalty in this case is an excise tax that is imposed for each employee who receives a premium tax credit or cost-sharing reduction for health insurance purchased through a state exchange - - the monthly penalty is equal to one-twelfth of $3,000 for each of those employees. The penalty for any month is capped at an amount equal to the number of full-time employees during the month (regardless of how many employees are receiving a premium tax credit or cost-sharing reduction) in excess of 30, multiplied by one-twelfth of $2,000. For example, if an employer has 70 full-time employees, if the employer offers health coverage, and if 15 of the 70 receive a tax credit for the year for enrolling in a state-offered exchange plan, the penalty will be $3,000 for each employee receiving a tax credit, for a total penalty of $45,000. The maximum penalty for this employer is capped at the amount of the penalty that would have been assessed for a failure to provide coverage, or $80,000 [$2,000, multiplied by 40 (70 minus 30)]. Since the calculated penalty of $45,000 is less than the $80,000 maximum amount, the penalty would be $45,000. The penalty is assessed on a monthly basis.

Requirement To Offer "Free Choice Vouchers." After 2013, employers offering minimum essential coverage through an eligible employer-sponsored plan and paying a portion of that coverage will have to provide "qualified employees" with a voucher whose value could be applied to purchase a health plan through an insurance exchange. Qualified employees are those employees (i) who do not participate in the employer's health plan, (ii) whose required contribution for employer sponsored minimum essential coverage exceeds 8%, but does not exceed 9.8% of household income, and (iii) whose total household income does not exceed 400% of the federal poverty level. The value of the voucher would be equal to the dollar value of the employer contribution to the employer offered health plan. Employers providing free choice vouchers would not be subject to penalties for employees that receive a voucher.

Tax Credits to Certain Small Employers that Provide Insurance. The new law provides small employers with a tax credit (i.e., a dollar-for-dollar reduction in tax) for nonelective contributions to purchase health insurance for their employees. The credit can offset an employer's regular tax as well as its alternative minimum tax liability.

"*Small Business Employers Eligible for the Credit*. To qualify, a business must offer health insurance to its employees as part of their

compensation and contribute at least half of the total premium cost. The business must have no more than 25 full-time equivalent employees ("FTEs"), and the employees must have annual full-time equivalent wages that average no more than $50,000. However, the full amount of the credit is available only to an employer with 10 or fewer FTEs and whose employees have average annual full-time equivalent wages from the employer of less than $25,000. The credit is reduced, per a formula, for employers having 11 to 25 employees and for employers whose average wages per employee is between $25,000 and $50,000."

"*Years the Credit Is Available*. The credit is initially available for any tax year beginning in 2010, 2011, 2012 or 2013. Qualifying health insurance for purposes of claiming the credit for this first phase of the credit is health insurance coverage purchased from an insurance company licensed under state law. For tax years beginning after 2013, the credit is only available to an eligible small employer that purchases health insurance coverage for its employees through a state exchange, and the credit is available for only two years. The maximum two-year coverage period does not take into account any tax years beginning in years before 2014. Thus, an eligible small employer could potentially qualify for this credit for six tax years, four years under the first phase and two years under the second phase."

"*Calculating the Credit*. For tax years beginning in 2010, 2011, 2012 or 2013, the credit is generally 35% (50% for tax years beginning after 2013) of the employer's nonelective contributions toward the

employees' health insurance premiums. The credit phases out as the size of the business and average wages increase. Tax-exempt small businesses meeting these requirements are eligible for payroll tax credits of up to 25% for tax years beginning in 2010, 2011, 2012 or 2013 (35% in tax years beginning after 2013) of the employer's nonelective contributions toward the employees' health insurance premiums."

"*Special Rules*. The employer is entitled to an ordinary and necessary business expense deduction equal to the amount of the employer contribution minus the dollar amount of the credit. For example, if an eligible small employer pays 100% of the cost of its employees' health insurance coverage, and if the amount of the tax credit is 50% of that cost (i.e., in tax years beginning after 2013), the employer can claim a deduction for the other 50% of the premium cost."

"Self-employed individuals, including partners and sole proprietors, two percent shareholders of an S corporation and five percent owners of the employer are not treated as employees for purposes of this credit. Any employee with respect to a self-employed individual is not an employee of the employer for purposes of this credit if the employee is not performing services in the trade or business of the employer. Thus, the credit is not available for a household employee of a sole proprietor of a business. A special rule prevents sole proprietorships from receiving the credit for the owner and their family members. Thus, no credit is available for any contribution to the purchase of health insurance for those individuals, and the individual is not taken into account in

determining the number of full-time equivalent employees or average full-time equivalent wages."

The "Cadillac Tax" on High-Cost Health Plans. The new law imposes an excise tax on high-cost employer-sponsored health coverage (often referred to as "Cadillac" health plans). It's a 40% excise tax on insurance companies, based on premiums that exceed certain amounts. The tax is not imposed on employers themselves unless they are self-funded. However, it is expected that employers and workers will ultimately bear this tax in the form of higher premiums passed on by insurers.

The new tax, which applies for tax years beginning after Dec. 31, 2017, places a 40% nondeductible excise tax on insurance companies and plan administrators for any health coverage plan to the extent that the annual premium exceeds $10,200 for single coverage and $27,500 for family coverage. An additional threshold amount of $1,650 for single coverage and $3,450 for family coverage will apply for retired individuals age 55 and older and for plans that cover employees engaged in high risk professions. The tax will apply to self-insured plans and plans sold in the group market, but not to plans sold in the individual market (except for coverage eligible for the deduction for self-employed individuals). Stand-alone dental and vision plans will be disregarded in applying the tax. The dollar amount thresholds will be automatically increased if the inflation rate for group medical premiums between 2010 and 2018 is higher than the Congressional Budget Office estimates in 2010. Employers with age and gender demographics that result in higher premiums could value the coverage provided to employees using the rates that would apply using a national risk pool. The excise tax will be levied at the insurer level. Employers will be required to aggregate the coverage subject to the limit and issue information returns for insurers indicating the amount subject to the excise tax.

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We hope this is helpful. Don't hesitate to reach out to your contacts here at Archer with any questions, or feel free to contact Gordon Moore who heads our Tax Group [856-354-3087 or gmoore@archerlaw.com].

Related People

Gordon F. Moore

Of Counsel

gmoore@archerlaw.com

856.354.3087

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