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IMPACT OF HEALTH CARE REFORM ON INDIVIDUAL AND SMALL BUSINESS TAXES

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Health Care Reform Affects Individual Taxes

In addition to significantly changing our health care and health-care delivery systems, and imposing new requirements upon employers and insurers alike, the newly-enacted health care reform laws contain a number of provisions that directly affect individuals by changing their tax situations, or by imposing additional tax liabilities. Some of these changes are described below. (See our earlier *Legal Alerts* dated March 24, 2010, April 13, 2010 and April 19, 2010, available at http://www.fordharrison.com, for a general description of the legislation.)

Required health insurance coverage

Under the new law, U.S. citizens and residents are required to have qualifying health coverage, and with certain exceptions (see below), after 2013, those who do not have qualifying health coverage will be subject to a tax penalty. This penalty will be equal to the greater of: (a) a specified flat dollar amount per taxpayer, up to a maximum of three times the specified amount per family, or (b) a percentage of household income over the threshold amount of income required for income tax return filing. (For 2010, this threshold for taxpayers under age 65 is $9,350 for individuals or $18,700 for couples filing a joint return.) The penalty will be phased in over three years, as follows:

	Flat Dollar Penalty	Family Maximum	Percentage of Income
2014	$95	$ 285	1.0%
2015	$325	$ 675	2.0%
2016 and later	$695	$2085	2.5%

After 2016, the penalty will be further adjusted annually for cost-of-living.

Exemptions will be available for financial hardship, as well as for: those taxpayers with religious objections to insurance; those taxpayers whose period without coverage was less than three months; aliens not lawfully present in the U.S.; individuals who are incarcerated; Native Americans; individuals whose least expensive available coverage option costs more than 8% of their household income; those taxpayers with household incomes below the tax-filing threshold; and persons who reside outside of the U.S.

Premium assistance tax credit

The new law provides a "premium assistance tax credit" to low- and middle-income individuals and families who purchase health insurance through a State Health Care Exchange. The premium assistance credit is a refundable credit, and is payable in advance directly to the insurer in order to subsidize the purchase of the health insurance. When an eligible individual enrolls in coverage through an Exchange, the individual reports his or her income to the Exchange. The Exchange then determines the individual's eligibility for a premium assistance credit based on income and the IRS pays the amount of the credit directly to the individual's insurance plan. The eligible individual then only must pay the difference between the premium assistance credit amount and the total premium charged for his or her coverage. If the eligible individual is employed, the net premium payments are made through payroll deductions.

This premium assistance credit is available on a "sliding scale" based on income, but will be available for individuals and families with household incomes not exceeding 4 times the federal poverty level (based on 2009 figures, this would be $43,320 for an individual or $88,200 for a family of four) who are not eligible for Medicaid, employer sponsored insurance, or other acceptable coverage.

Higher Medicare taxes on some taxpayers

Under current law, all of an employee's wages are subject to a 2.9% Medicare payroll tax, paid 1.45% each by the employee and the employer. Individuals who are self-employed pay the full 2.9%, but are allowed an income-tax deduction for one-half of that amount. This tax is the main source of financing for Medicare's hospital insurance trust fund, which covers hospital bills for individuals who are 65 and older or who are disabled. Beginning in 2013, single people earning over $200,000 and married couples earning over $250,000 will be subject to an additional 0.9% Medicare tax (2.35% in total) on earnings in excess of those amounts. Self-employed individuals will also pay an additional 0.9% (3.8% total) on self-employment earnings over the threshold.

Also beginning in 2013, a Medicare tax will apply to certain investment income. A new 3.8% tax will be imposed on "net investment income" of single taxpayers with adjusted gross income above $200,000 and joint filers with AGI above $250,000. Net investment income means interest, dividends, royalties, rents, gross income from a trade or business involving passive activities, and net gain from disposition of property (other than property held in a trade or business), reduced by deductions properly allocable to such income. However, the new tax will apply only to income that exceeds the $200,000 or $250,000 thresholds. For example, if an individual taxpayer earns $180,000 in wages and has net investment income of $30,000, only $10,000 of that net investment income will be subject to the new tax. Also, the new tax will not apply to income earned within tax-deferred retirement accounts such as 401(k) plans or IRAs.

Limit health FSAs to $2,500

Under current law, there is no limit on the amount that can be set aside and reimbursed under a health flexible spending account ("FSA"). Under the new law, however, beginning in 2013, a cap of $2,500 will apply to the amount that may be reimbursed, or that may be made available for reimbursement, under a health FSA. This dollar amount will be indexed for inflation after 2013.

Prohibit reimbursement for over-the-counter medications

Effective after 2010, the new law prohibits purchase of, or reimbursement for the costs of, over-the-counter drugs (non-prescription) through health reimbursement accounts (HRAs) or health flexible spending accounts (FSAs), as well as tax-free reimbursement of those amounts through health savings accounts (HSAs) or Archer Medical Savings Accounts (MSAs).

Increased penalties on nonqualified distributions from HSAs and Archer MSAs

The new law increases the penalty tax on distributions that are made from health savings accounts (HSAs) or Archer MSAs but that are not used for qualified medical expenses, from 10% or 15%, respectively, to 20% of the distributed amount, effective with respect to distributions made after December 31, 2010.

Floor on medical expense deduction increased to 10%

Under current law, taxpayers can deduct unreimbursed medical expenses to the extent that those expenses exceed 7.5% of the taxpayer's AGI. The new law raises that threshold for most taxpayers from 7.5% of AGI to 10%, effective for tax years beginning after December 31, 2012. The threshold for individuals age 65 and older (and their spouses) remains at 7.5% through 2016.

Dependent coverage in employer health plans

Effective March 30, 2010, the new law extended the exclusion from income for medical care expense reimbursements under an employer-provided accident or health plan to reimbursements of expenses for a child of an employee who has not yet attained age 27 as of the end of the tax year. This change is also intended to apply to the exclusion for the value of employer-provided coverage under an accident or health plan. In addition, the deduction available to self-employed individuals for the health insurance costs applies to health insurance costs for any child of the taxpayer who has not attained age 27 as of the end of the tax year.

Excise tax on indoor tanning services

Beginning July 1, 2010, the new law imposes a 10% excise tax on indoor tanning services. The tax will be paid by the individual who receives the tanning services but will be collected and remitted to the IRS by the person who receives payment for the tanning services (e.g., a tanning salon).

Liberalized adoption credit and adoption assistance rules

For tax years beginning in 2010, the adoption tax credit is increased by $1,000 (to $13,170), made refundable, and extended through 2011. The exclusion for employer-provided adoption assistance is also increased to $13,170.

Small Business Tax Effects of the Health Care Reform Legislation

For owners of small businesses and their workers, the health care reform legislation has some key tax-related provisions, including tax credits, excise taxes and penalties. But whether a business will be affected by these taxes depends on a variety of factors, such as the number of employees that the business has. The following is an overview of some of those provisions.

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 towards the purchase of health insurance for their employees. The credit can offset the employer's regular tax or its alternative minimum tax (AMT) 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 must contribute at least half the total premium cost. To qualify for any credit, 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.

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 "full-time equivalent" employee and all other employees are counted on a pro-rated basis, *e.g.*, an employee averaging 20 hours per week is counted as two-thirds of a "full-time equivalent" employee.

Years the credit is available. The credit is initially available for any tax year beginning in 2010, 2011, 2012, or 2013, in which health insurance coverage is 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 Health Care Exchange and is only available for a two-year period. The maximum two-year coverage period does not take into account any tax years beginning before 2014. Thus, an eligible small employer could potentially qualify for this credit for six of its tax years – four years under the first phase and two years under the second phase.

Calculating the amount of the credit. For tax years beginning before 2014, the credit is generally 35% of the employer's nonelective contributions toward the employees' health insurance premiums; the percentage increases to 50% for years after 2013. The credit phases out as firm size and average wages increase.

The employer remains 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 were to pay 100% of the cost of its employees' health insurance coverage and the amount of the tax credit is 50% of that cost (i.e., in tax years beginning after 2013), the employer can still claim a deduction for the other 50% of the premium cost.

Self-employed individuals, including partners and sole proprietors, two-percent shareholders of a subchapter-S corporation, and five-percent owners of an employer are not treated as employees for purposes of this credit. There is also a special rule to prevent sole proprietorships from receiving the credit for their owners and the owners' family members. Thus, no credit is available for any contribution towards the purchase of health insurance for these individuals and the individual is not taken into account in determining the number of full-time equivalent employees or average full-time equivalent wages.

Most small businesses not subject to penalty

Although beginning January 1, 2014 the new law imposes penalties on certain businesses for not providing coverage to their employees (the so-called "pay or play" requirement), most small businesses won't have to worry about this provision because employers with fewer than 50 employees aren't subject to the "pay or play" penalty. Only an "applicable large employer," defined as an employer who employed an average of at least 50 FTEs during the preceding calendar year, is subject to the requirement to offer coverage. Most small businesses, since they have fewer than 50 employees, are thus exempt from this requirement. However, even an employer with 50 or more FTEs isn't subject to the penalty for not offering coverage if the employer has no full-time employees who are certified to the employer as having purchased health insurance through a state Exchange with respect to which a tax credit or cost-sharing reduction is allowed or paid to the employee.

For businesses with at least 50 FTEs, and at least one full-time employee who receives a premium tax credit or cost-sharing reduction, the possible penalties vary depending on whether or not the employer offers health insurance to its employees.

Penalty for employers not offering coverage. An applicable large employer who fails to offer its full-time employees and their dependents the opportunity to enroll in minimum essential coverage under an employer-sponsored plan for any month is subject to a penalty if at least one of its full-time employees is certified to the employer as having enrolled in health insurance coverage purchased through a state Exchange with respect to which a premium tax credit or cost-sharing reduction is allowed or paid to the employee. The penalty for any month is an excise tax equal to the number of FTEs over a 30-employee threshold during the applicable month (regardless of how many employees are receiving a premium tax credit or cost-sharing reduction) multiplied by one-twelfth of $2,000. For example, if an employer fails to offer minimum essential coverage and has 60 full-time employees, ten of whom receive a tax credit for the year for enrolling in a state Exchange-offered plan, the employer will owe $2,000 for each employee over the 30-employee threshold, for a total penalty of $60,000 ($2,000 multiplied by 30 (60 minus 30)). This penalty is computed and assessed on a monthly basis.

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. The penalty 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. For each full-time employee receiving a premium tax credit or cost-sharing subsidy through a state Exchange for any month, the employer is required to pay an amount equal to one-twelfth of $3,000. The penalty for each employer for any month is capped at an amount equal to the number of FTEs 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 offers health coverage and has 60 full-time employees, 15 of whom receive a tax credit for the year for enrolling in a state Exchange-offered plan, the employer will owe a penalty of $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 it would have been assessed for a failure to provide coverage, or $60,000 ($2,000 multiplied by 30 (60 minus 30)). Since the calculated penalty of $45,000 is less than the maximum amount, the employer pays the $45,000 calculated penalty. This penalty is computed and 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 the Exchange. Qualified employees would be those employees: who do not participate in the employer's health plan; whose required contribution for employer sponsored minimum essential coverage exceeds 8%, but does not exceed 9.8% of household income; and whose total household income does not exceed 400% of the poverty line for the family. 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 will not be subject to penalties for employees that receive a voucher.

Tax on high-cost ("Cadillac") health plans

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

The new tax, which goes into effect for tax years beginning after Dec. 31, 2017, imposes a 40% nondeductible excise tax on insurance companies and plan administrators for any health plan to the extent that the annual premium exceeds $10,200 for single coverage and $27,500 for family coverage. An additional $1,650 for single coverage and $3,450 for family coverage is added to the threshold 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 the cost of which is deductible for self-employed individuals). Stand-alone dental and vision plans are disregarded in applying the tax. The dollar thresholds will be automatically increased if the inflation rate for group medical premiums between 2010 and 2018 turns out to be higher than projected. 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. Employers will be required to aggregate the coverages that are subject to the limit and to issue information returns for insurers indicating the amount subject to the excise tax.

If you have any questions regarding this article, or would like additional details concerning the new law or concerning the matters discussed above, you can contact the author of this article, Jeffrey Ashendorf, 212-453-5926, jashendorf@fordharrison.com, any member of Ford & Harrison's Employee Benefits practice group or the Ford & Harrison attorney with whom you usually work.