



August 2010

Dear Client:

As you probably know, on March 30, 2010, President Obama signed into law the final piece of his promised Health Reform legislation. Once fully phased in (which isn't scheduled to happen until 2018), the legislation will provide health care coverage to some 32 million uninsured citizens, and make it more affordable for millions more, by expanding Medicaid, requiring the establishment of state-run Insurance Exchanges, through which certain individuals and families can receive federal subsidies (credits) in order to substantially reduce the cost, forbidding insurance companies from excluding coverage for pre-existing conditions (effective this year for children and in 2014 for adults), establishing temporary (through 2014) high-risk insurance pools for adults with pre-existing conditions, and requiring health plans to allow parents to keep their children on their family plans until they reach age 26.

This Health Reform legislation covers numerous areas, and affects both income tax and non-income tax related business planning. This letter briefly summarizes the tax provisions affecting individuals and small to midsized businesses, and is presented based on the timeline for when the various provisions are scheduled to take effect.

Provisions Effective in 2010:

**Small Employer Health Insurance Tax Credit:** Effective this year and going through 2013, the Health Reform legislation provides a new tax credit for small employers that purchase health insurance for their employees. To be a small employer qualifying for this new credit you must:

1. Employ no more than 25 Full-time Equivalent (FTE) employees during the tax year,
2. Pay annual FTE wages that average no more than \$50,000 for the year, and
3. Have a qualified health insurance plan (or arrangement), under which you pay at least 50% of the cost of the premiums (on a uniform basis), for employees who enroll in the plan.

Generally, to qualify for the credit, the employer must pay the same percentage (which has to be at least 50%) for all of its employees' premiums. However, under a transition rule for 2010 only, an employer can qualify even if it pays differing percentages of different employees' premiums, as long as all the employer payments are at least 50% of each employee's premium (based on single-employee only-coverage). Also, premiums paid in 2010 before the Health Reform legislation was enacted, can qualify for the credit

The credit generally equals 35% of the amounts paid by the employer during the year for employee coverage. However, the full amount of the credit is available only for employers that employ 10 or fewer FTE employees, and have average annual FTE wages of less than \$25,000 for the year. Also, no credit is allowed for premiums paid on behalf of partners, sole proprietors, 2% shareholders of an S corporation, 5% owners of the employer, and dependents of these individuals. Other limitations may apply as well.

The small employer health insurance credit will be claimed on the employer's income tax return. It can offset regular income taxes and alternative minimum tax. Any unused credit can

be carried back for one year (but not before 2010), and forward for up to 20 years, in order to offset future income taxes.

**Note:** In 2014, and later, eligible small employers who purchase coverage through a state-run Insurance Exchange (which the Health Reform legislation requires states to establish) will be eligible for a tax credit for two years, of up to 50% of their contribution. Also, the wage limits will be indexed beginning in 2014.

**Liberalized Adoption Credit and Adoption Assistance Exclusion:** For 2010, the Health Reform legislation increases the adoption credit, and the employer-provided adoption assistance exclusion to \$13,170 (from \$12,170). It also makes the credit refundable, and extends both the exclusion and credit through 2011.

**Dependent Coverage in Employer Health Plans:** Effective March 30, 2010, the Health Reform legislation provides that self-employed individuals can deduct (as a self-employed medical insurance deduction on page 1 of Form 1040) insurance coverage for their children, who have not attained age 27, as of the end of the year. Similarly, employees can exclude from their taxable income the amounts their employer pays for health care insurance and expense reimbursements for their children, who have not attained age 27, as of the end of the year. To qualify for this tax break, the child must be the individual's son, daughter, stepson, stepdaughter, or eligible foster child. The child does not have to be the individual's dependent.

Although the exclusion for employer-provided health coverage for under-age-27 dependents is effective March 30, 2010, employers don't have to provide health coverage of these adult children, if they don't otherwise cover dependents. If the employer plan does cover dependents, it must change its definition of "dependent" to include an employee's unmarried children up to age 26, but not until its plan year beginning after September 22, 2010. Thus, employees may well have to wait until 2011, before they have an opportunity to cover these adult children, and even then, only if their employer's health plan otherwise covers dependents, and the child is unmarried and under age 26. (The under-age-26 and marital status requirements appear to be a glitch in the law. Hopefully, future legislation will change this definition, so that it is the same as for the income exclusion requirement where the child simply has to be under age 27.)

#### Provisions Effective in 2011:

**Cost of Employer Sponsored Health Coverage Included on Form W-2:** Beginning in 2011, employers will have to start reporting the value of health insurance coverage they provide to employees, on the employee's annual Form W-2.

**Over-the-counter Medicine No Longer Reimbursable by Health Plans:** Under pre-Health Reform law, health plans [including health FSAs, Health Reimbursement Accounts (HRAs), Health Savings Accounts (HSAs), and Archer Medical Savings Accounts (MSAs)] could reimburse, on a tax-free basis, the cost of medicine, regardless of whether it was prescribed by a doctor. On the other hand, only medicine (other than insulin) that required a doctor's prescription was deductible for income tax purposes (as an itemized deduction). Beginning in 2011, the Health Reform legislation provides that only insulin and doctor prescribed medicine qualifies for tax-free reimbursement through a health FSA, HRA, HSA, or Archer MSA. Thus, as with the itemized deduction for medical expenses, non-prescribed medicine (other than insulin) will not qualify for tax-free reimbursement.

**Increased Tax on Non-qualifying HSA and Archer MSA Distributions:** Beginning in 2011, the additional tax for HSA withdrawals, made before the owner turns age 65, that are not used for qualified medical expenses is increased from 10% to 20%. Similarly, the additional tax for post-2010 Archer MSA withdrawals, which are not used for qualified medical expenses, is increased from 15% to 20%.



**Simple Cafeteria Plans Available for Small Employers:** Starting in 2011, a new cafeteria plan, known as a Simple Cafeteria Plan, will be available to small employers that employed an average of 100 or fewer employees during either of the two preceding years. Basically, the Simple Cafeteria Plan and the benefits it provides (including group term life insurance, self insured medical expense reimbursements, and dependent care assistance) will be treated as meeting the applicable nondiscrimination rules, if the cafeteria plan satisfies certain minimum eligibility, participation, and contribution requirements. This should make it simpler for small employers to provide tax-free benefits to their employees.

#### Provisions Effective in the Future:

In upcoming years, the following provisions will take effect respectively:

#### **Provisions Effective in 2012:**

- Corporate Information Reporting

#### **Provisions Effective in 2013:**

- Additional Hospital Insurance Tax for High Wage Workers
- New 3.8% Surtax on Unearned Income
- Increased Medical Expense Deduction Threshold
- New Limit on Health FSA Contributions
- Deduction for Retiree Drug Coverage Eliminated

#### **Provisions Effective in 2014:**

- Penalty for Not Having Health Insurance Coverage
- Health Care Cost-sharing Subsidies (or Tax Credits) to Low-income Individuals
- Penalty for Employers Not Offering Affordable or Adequate Health Insurance Coverage
- Free Choice Voucher

#### **Provisions Effective in 2018:**

- Excise Tax on High-cost Employer-sponsored Health Coverage (Cadillac Plans)

#### Conclusion

This is intended to briefly summarize the Health Reform Act tax provisions affecting individuals, and small to mid-sized businesses. Please contact us if you have questions or want more detailed information on the Health Reform Act tax provisions.

Best Regards,  
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