



April 19, 2010

To Our Clients and Friends:

As you probably know, on March 30, 2010, President Obama signed into law the final piece of his promised Health Reform legislation. Whether you are for or against it, no one can argue that this is not landmark legislation that will result in a monumental shift in how health care is delivered in this country. Once fully phased in (which is not scheduled to happen until 2018), the legislation will provide health care coverage to approximately 32 million uninsured individuals 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) 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.

Obviously, this is not an inexpensive undertaking—the 10-year price tag is estimated to be \$938 billion, which is largely paid for through significant tax increases on higher income taxpayers, forecasted Medicare reimbursement savings, and various revenue raisers targeting specific health-related industries. Also, as is often the case, many of the carrots and sticks designed to persuade people to act as the government deems appropriate (i.e., to get or provide health insurance coverage) reside in our tax system. Namely, small employers are provided tax credits to encourage them to provide employee health coverage. Large employers are assessed excise taxes to discourage them from not providing employee health coverage (or providing unaffordable or inadequate coverage), while individuals are assessed excise taxes to discourage them from opting out of coverage.

This Health Reform legislation is massive—it is well over two thousand pages—and covers numerous areas, both tax and nontax. This letter briefly summarizes the tax provisions affecting individuals and small to mid-sized businesses and is presented based on the timeline for when the 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.

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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 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%) of all 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 20 years to offset future 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 3/30/10, 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 3/30/10, employers do not have to provide health coverage of these adult children if they do not 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 9/22/10. 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.)

**Codification of Economic Substance Doctrine and Imposition of Penalties.** The economic substance doctrine is a judicial doctrine that the courts have used inconsistently over the years to deny tax benefits when the transaction generating these tax benefits lacked economic substance. The Health Reform legislation clarifies the manner in which the economic substance doctrine should be applied by the courts. It also imposes a 20% penalty on understatements attributable to a transaction lacking economic substance.

### **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 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, nonprescribed medicine (other than insulin) will not qualify for tax-free reimbursement.

**Increased Tax on Nonqualifying 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 that 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 2012**

**Corporate Information Reporting.** Beginning in 2012, businesses that pay more than \$600 during the year to corporate providers of property and services will have to file an information report with each provider and the IRS. This will likely be done on Form 1099-MISC, Miscellaneous Income.

### **Provisions Effective in 2013**

**Additional Hospital Insurance (HI) Tax for High Wage Workers.** Beginning in 2013, the employee portion of the HI tax rate will be increased by 0.9% for employees who earn wages over \$200,000 (\$250,000 for married couples filing jointly or \$125,000 for married filing separate). Similarly, an additional HI tax of 0.9% will be imposed on self-employment income in excess of \$200,000 (\$250,000 for married couples filing jointly or \$125,000 for married filing separate) reduced (but not below zero) by wages taken into account in determining the FICA tax with respect to the taxpayer.

**Note:** The \$150,000/\$200,000/\$250,000 thresholds are not indexed for inflation.

**New 3.8% Surtax on Unearned Income.** Beginning in 2013, taxpayers with modified adjusted gross income (MAGI) over \$200,000 (\$250,000 for a joint return or \$125,000 for married filing separate) will be subject to a 3.8% surtax (called the Unearned Income Medicare Contribution) on net investment income. Specifically, the tax equals 3.8% of the lesser of the following two amounts:

1. Net investment income (interest, dividends, royalties, rents, and gains on the sale of investment property).
2. The excess of MAGI over \$200,000 (\$250,000 for a joint return or \$125,000 for married filing separate). MAGI is AGI increased by the amount excluded from income as foreign earned income, net of the deductions and exclusions disallowed with respect to the foreign earned income.

The tax also applies to estates and trusts. In this case, the tax is 3.8% of the lesser of (1) undistributed net investment income or (2) the excess of AGI over the dollar amount at which the highest estate and trust income tax bracket begins.

**Increased Medical Expense Deduction Threshold.** Beginning in 2013, the threshold for the itemized deduction for medical expenses for regular income tax purposes will be increased from 7.5% of AGI to 10% of AGI.

However, for 2013 through 2016, if either the taxpayer or the taxpayer's spouse turns 65 before the end of the tax year, the increase will not apply and the threshold will remain at 7.5% of AGI. Thus, the 10% threshold will not apply to seniors and their spouses until after 2016.

**New Limit on Health FSA Contributions.** Beginning in 2013, the maximum amount that an individual can contribute to an employer-provided health Flexible Spending Account (FSA) will be \$2,500 per year. Note, however, that health FSA plans can (and typically do) limit contributions to an amount that is less than \$2,500 per year. Therefore, this change may have little or no impact on you.

**Deduction for Retiree Drug Coverage Eliminated.** A number of large employers provide prescription drug coverage for their Medicare Part D eligible retirees, which is subsidized by the Department of Health and Human Services (HHS). This subsidy is excluded from the company's income, and under pre-Health Reform law, it did not reduce the deduction otherwise allowed for the payment. Starting in 2013, this is no longer true—the subsidy will reduce the allowed deduction. (As a result of this change, several large companies have already announced that they are reconsidering providing this retiree benefit.)

## **Provisions Effective in 2014**

**Penalty for Not Having Health Insurance Coverage.** Beginning in 2014, most U.S. citizens and legal residents will have to maintain health care coverage or pay a penalty based on their household income and the number of uninsured individuals in the household. The penalty per household will generally be capped at \$285 for 2014, \$975 for 2015, and \$2,085 for 2016. Individuals who, based on their household income, cannot afford coverage under their employer sponsored health plan are exempted from the penalty, as are individuals who reside outside the U.S. and those with certain religious beliefs.

This penalty was provided as a means to force individuals to obtain health insurance coverage. Payment of the penalty does not entitle them to any health insurance coverage.

**Health Care Cost-sharing Subsidies (or Tax Credits) Available to Low-income Individuals.** Beginning in 2014, a cost-sharing subsidy (or tax credit) will be provided to low-income individuals to help cover their health insurance costs. Basically, 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 for 2009) that are not eligible for Medicaid, employer sponsored insurance, or other acceptable coverage will be able to obtain cost-sharing subsidies or tax credits that can be used to reduce premiums for health insurance obtained through the newly established state-run Insurance Exchanges.

**Penalty for Employers Not Offering Affordable or Adequate Health Insurance Coverage.**

Beginning in 2014, *large employers* not offering health insurance coverage for all their full-time employees, or offering unaffordable or inadequate health insurance coverage, will have to pay a penalty if *any* full-time employee uses a tax credit or cost-sharing subsidy to purchase health insurance through a state-run Insurance Exchange. A *large employer* is, generally, an employer that employed an average of at least 50 full-time employees during the preceding calendar year. Any penalty paid under this provision is not deductible as a business expense.

**Free Choice Vouchers.** Beginning in 2014, employers that have a health plan (or arrangement) under which they pay a portion of their employees' health insurance coverage will have to provide certain low-income employees who do not participate in the employer's plan with a voucher (equal to the amount the employer would have contributed to the employer-offered health plan if the employee had participated) that can be applied to purchase health insurance through a state run Insurance Exchange.

**Provisions Effective in 2018**

**Excise Tax on High-cost Employer-sponsored Health Coverage (Cadillac Plans).** The last piece of the Health Reform legislation kicks-in for 2018 when a nondeductible excise tax will be levied on so-called Cadillac plans—basically health plans with annual premiums exceeding \$10,200 for single coverage and \$27,500 for family coverage.

However, higher thresholds apply for retired individuals age 55 and older and for plans that cover employees engaged in high-risk professions. 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.

**Conclusion**

There you have it—an extremely brief summary of the Health Reform Act tax provisions affecting individuals and small to mid-sized businesses. Please give us a call if you have any questions or need any additional information.

Very truly yours,

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