

2010 Health Reform: Solution or Confusion.

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Before the 2010 Health Reform Act, when it came to your healthcare coverage, you were either comfortable and happy, or you were unhappy with or uncovered by a reasonable insurance policy. After the 2010 Health Reform Act, if you were comfortable you are probably now uncomfortable, and if you were unhappy or uncovered you are probably still so and now you can probably add confused to that description. We have sorted through the law and have deciphered the most impactful changes for both individuals and for employers.

Changes that impact Individuals:

Individual mandate: The new law contains an "individual mandate", a requirement that U.S. citizens and legal residents have qualifying health coverage or be subject to a tax penalty. The penalty will be phased in beginning in 2014. However, there are provisions that allow for exemptions for financial hardship, religious objections, American Indians, those without coverage for less than three months, aliens not lawfully present in the U.S., incarcerated individuals, those for whom the lowest cost plan option exceeds 8% of household income, those with incomes below the annual tax filing threshold and those residing outside of the U.S.

Health Insurance Premium Assistance Credits: 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 refundable tax credit (the "premium assistance credit") for eligible individuals and families who purchase health insurance through an Exchange.

Higher Medicare taxes on high-income earners: High-income taxpayers will be hit with a double whammy: a tax increase on wages and a new levy on investments. The Medicare payroll tax is the primary source of financing for Medicare's hospital insurance trust fund, which pays hospital bills for beneficiaries, who are 65 and older or disabled. Under current law, wages are subject to a 2.9% Medicare payroll tax. Workers and employers pay 1.45% each. Self-employed people pay both halves of the tax (but are allowed to deduct half of this amount for income tax purposes). Unlike the payroll tax for Social Security, which applies to earnings up to an annual ceiling (\$106,800 for 2010), the Medicare tax is levied on all of a worker's wages without limit. Under the provisions of the new law, which take in 2013, most taxpayers will continue to pay the 1.45% Medicare hospital

insurance tax, but single people earning more than \$200,000 and married couples earning more than \$250,000 will be taxed at an additional 0.9% (2.35% in total) on the excess over those base amounts. Employers will collect the extra 0.9% on wages exceeding \$200,000 just as they would withhold Medicare taxes and remit them to the IRS. Some employees will have to remit additional Medicare taxes when they file income tax returns, and some will get a tax credit for amounts overpaid. Self-employed persons will pay 3.8% on earnings over the threshold.

Medicare payroll tax extended to investments. Under current law, the Medicare payroll tax only applies to wages. Beginning in 2013, a Medicare tax will, for the first time, be applied to investment income. A new 3.8% tax will be imposed on net investment income of single taxpayers with AGI above \$200,000 and joint filers over \$250,000. Net investment income is interest, dividends, royalties, rents, gross income from a trade or business involving passive activities, and net gain from disposition of property. However, the new tax won't apply to income in tax-deferred retirement accounts such as 401(k) plans. Also, the new tax will apply only to income in excess of the \$200,000/\$250,000 thresholds. So, if a couple earns \$200,000 in wages and \$100,000 in capital gains, \$50,000 will be subject to the new tax. Because the new tax on investment income won't take effect for three years, there is more time for Congress and the IRS to tinker with it. So we can expect lots of refinements and "clarifications" between now and when the tax is actually rolled out in 2013.

Floor on medical expenses deduction increased from 7.5% of adjusted gross income (AGI) to 10%: The new law raises the floor beneath itemized medical expense deductions from 7.5% of AGI to 10%, effective for tax years beginning after Dec. 31, 2012. The AGI floor for individuals age 65 and older (and their spouses) will remain unchanged at 7.5% through 2016.

Increased penalties on nonqualified distributions from HSAs and Archer MSAs: The new law increases the tax on distributions from a health savings account or an Archer MSA that are not used for qualified medical expenses to 20% (from 10% for HSAs and from 15% for Archer MSAs) of the disbursed amount, effective for distributions made after Dec. 31, 2010.

Limit reimbursement of over-the-counter medications from HSAs, FSAs, and MSAs: The new law excludes the costs for over-the-counter drugs not prescribed by a doctor from being reimbursed through a health reimbursement account (HRA) or health flexible savings accounts (FSAs) 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 after Dec. 31, 2010.

Dependent coverage employer health: Effective on the enactment date, the new law extends the general exclusion 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. 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.

Limit health flexible spending arrangements (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 or other expenses. Under current law, there is no limit on the amount of contributions 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.

Changes that affect Employers:

For corporations, owners of small businesses and their workers, the recently enacted health reform legislation and the HIRE Act have some key provisions to which we must pay attention. The major ones include: tax credits; excise taxes; and penalties. But whether a business will be affected by them depends on a variety of factors, such as the number of employees the business has. We are writing to give you an overview of the provisions in these new laws with the largest impact on small business. Please call our offices for details of how the new changes may affect your specific business.

Small Tax-Exempt Organizations: There is news for Tax-Exempt Organizations with Annual Gross Receipts under \$25,000. Many of these organizations may have missed a May 17, 2010 deadline for filing a Form 990-N. The IRS commissioner has given his assurance that small tax-exempts will not be hurt by this. The IRS will be providing additional guidance in the near future on how it will help these organizations maintain their tax exempt status. The Commissioner's statement urges any affected organization to file Form 990-N.

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 non-elective contributions to purchase health insurance for their employees. The credit can offset an 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 contribute at least half 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.

Years the credit is available: The credit is initially available for any tax year beginning in 2010, 2011, 2012, or 2013.

Determine the amount of the credit: For tax years of 2010, 2011, 2012, or 2013, the credit is generally 35% of the employer's non-elective contributions toward the employees' health insurance premiums. The credit phases out as firm-size and average wages increase. 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. Thus, no credit is available for any contribution to 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.

Small businesses exemptions from penalties for not offering coverage to their employees: Although the new law imposes penalties on certain businesses for not providing coverage to their employees (so-called "pay or play"), 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. These provisions take effect Jan. 1, 2014.

The "Cadillac tax" on high-cost 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 they are self-funded (this typically occurs at larger firms). 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, applies for tax years after 2017.

The Hiring Incentives to Restore Employment (HIRE) Act

Two New Tax Benefits Aid Employers Who Hire and Retain Unemployed Workers: Two new tax benefits are now available to employers hiring workers who were previously unemployed or only working part time. These provisions are part of the Hiring Incentives to Restore Employment (HIRE) Act recently enacted into law.

Employers who hire unemployed workers this year (after Feb 3, 2010 and before Jan 1, 2011) may qualify for a 6.2% payroll tax incentive, in effect exempting them from their share of Social

Security taxes on wages paid to these workers after March 18th, 2010. This reduced tax withholding will have no effect on the employee's future Social Security benefits, and employers would still need to withhold the employee's 6.2% share of Social Security taxes, as well as income taxes. The employer and employee's share of Medicare taxes would also still apply to these wages.

In addition for each worker retained for at least a year, businesses may claim an additional general business tax credit, up to \$1,000 per worker, when they file their 2011 income tax returns.

The two tax benefits are especially helpful to employers who are adding positions to their payrolls. New hires filling existing positions also qualify but only if the workers they are replacing left voluntarily or for cause. Family members and other relatives do not qualify.

In addition, the new law requires the employer get a statement from each eligible new hire certifying that he or she was unemployed during the 60 days before beginning work or, alternatively, worked no more than 40 hours for anyone during the 60 day period. The IRS is currently developing a form employees can use to make the required statement.

Businesses, agricultural employers, tax-exempt organizations and public colleges and universities all qualify to claim the payroll tax benefit for eligible newly-hired employees.

In Summary, whether you are an individual employee or an employer, there are potentially significant changes in the future. This should give you enough information to ease any uncertainty to how you might be affected, at least until any additional adjustment and corrections occur, which so often happens on legislation of this scale.