



Health Care Reform Overview

MAY 2010

As you probably know, earlier this year the highly debated Health Reform legislation was enacted. This legislation will have a significant impact on individuals and businesses both in terms of taxes and how employers offer health benefits to employees as well as the overall mandate that most individuals carry some sort of health insurance.

This legislation is massive and covers numerous areas. Many individual taxpayers will first be directly impacted by the additional tax on wage and self employment income beginning in 2013. Additionally, a new tax on investment income is scheduled to go into effect in 2013. Investors may want to consider changing their investment strategies, to the extent possible, to minimize the impact of this tax.

Businesses will be primarily concerned with the penalties arising from not providing affordable medical coverage beginning in 2014.

Given the complexity of this legislation, the manner in which the Treasury Department and other agencies interpret and enforce these statutes will have a significant impact. There are still many unanswered questions about the new law.

We've outlined below some of the provisions with the broadest reach to our clients arranged by effective date.

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 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.

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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.

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 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 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.)

Provisions Effective in 2011

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

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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.

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. This change will likely result in businesses having to file far more Forms 1099s than before this provision was enacted.

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 over \$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. There is no additional HI tax imposed on the employer. However, the employer will be responsible to withhold the employee's additional HI tax.

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 (basically, interest, dividends, royalties, rents, income from passive activities 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

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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 won't apply and the threshold will remain at 7.5% of AGI. Thus, the 10% threshold won't 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.

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, can't 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 entice 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. The calculation of the penalty is beyond the scope of this Alert, but employers should plan on paying approximately \$2,000 per employee for all employees (not just those who receive a

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tax credit) for purposes of this penalty. The first 30 employees, however, are not considered in this calculation. Alternative calculation methods exist which may result in a lower penalty.

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.

The above description is a high level overview of the aspects of this new legislation which have the greatest impact to most individual and closely held business taxpayers. This Alert does not

address all of the details contained in the new legislation.

As the various effective dates approach, we expect more guidance on these changes. Even though there may be increases in tax and benefit costs in the years ahead, taxpayer's should use this lead time to plan for these changes and seek to minimize their impact, to the extent possible.

Please contact your W&G tax advisor to discuss how these changes will impact you.

Any U.S. tax advice contained in this communication is not intended or written to be used, and cannot be used, for the purpose of avoiding tax penalties that may be imposed on the taxpayer.

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