HEALTH CARE ACT TAX OVERVIEW

EMPLOYERS

Don't let tax-related compliance requirements take your organization by surprise

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Two major developments last year — the U.S. Supreme Court upholding most provisions of the Patient Protection and Affordable Care Act of 2010 and President Obama being re-elected — make it appear that the health care act is here to stay. Employers face a variety of tax-related compliance requirements under the act. Perhaps the most notable is the "play or pay" provision. It had been scheduled to go into effect in 2014, but it has been deferred to 2015 (along with certain information-reporting requirements). But small employers may already be eligible for a tax-saving opportunity.

Many of the health care act's tax-related provisions require employers to act this year and next. So it's important to take time now to determine what you need to do. Here's a closer look at key tax provisions and proposed IRS guidance (which can be relied on for filing purposes). Additional rules apply, so consult your tax advisor to determine exactly how your organization will be affected.

"Play or pay" provision

The shared responsibility provision, commonly referred to as "play or pay," doesn't *require* employers to provide health care coverage, but it in some cases imposes penalties on "large" employers that don't offer "minimum essential" coverage or that offer coverage that is "unaffordable" or that doesn't provide "minimum value."

Although the play-or-pay provision now won't take effect until Jan. 1, 2015, employers that could be subject to the penalties should start reviewing their workforces and coverage offerings now to determine whether there are any changes they should make to avoid or minimize penalties.

Shared responsibility basics

The play-or-pay provision imposes a penalty on large employers that don't offer minimum essential health care coverage to their full-time employees (and their dependents) if just one full-time employee receives a premium tax credit. Under the health care act, premium tax credits are available to employees who enroll in a qualified health plan through a government-run Health Insurance Marketplace (originally referred to as a "health insurance exchange") and meet certain income requirements — but only if they don't have access to minimum essential coverage from their employer or the employer coverage offered is unaffordable or doesn't provide minimum value.

Minimum essential coverage is provided by "eligible employer-sponsored plans." These include plans offered in a state's small or large group market and self-funded plans, but not certain limited-coverage plans, such as dental-only plans.

A large employer is one with at least 50 full-time employees, or a combination of full-time and part-time employees that's "equivalent" to at least 50 full-time employees. A full-time employee is someone employed on average at least 30 hours per week. The monthly equivalent of 30 hours per week is 130 hours of service in a calendar month.

Determining large employer status

Large employer status is determined by calculating full-time equivalent employees (FTEs) and adding that number to the total number of actual full-time employees. For a given calendar month, this requires totaling the hours of service for all part-time employees and dividing that figure by 120.

For hourly employees, the hours should be calculated based on records of hours worked and hours for which payment is made or due for vacation, holiday, illness, incapacity (including disability), layoff, jury duty, military duty or leave of absence.

For salaried employees, there are three methods of determining the hours:

1. The same method used for hourly employees,
2. A days-worked equivalency method (each worker is credited with eight hours for each day worked), or
3. A weeks-worked equivalency method (each worker is credited with 40 hours for each week worked).

You can apply different methods for different classifications of nonhourly employees, so long as the classifications are "reasonable and consistently applied."

Employers must determine annually, based on their employees' actual hours of service, whether they'll be considered a large employer for the next year.

Assessing affordability and minimum value

A large employer that offers minimum essential health coverage could nonetheless be subject to penalties if at least one full-time employee receives a premium tax credit because the coverage offered to the employee either wasn't affordable or didn't provide minimum value.

Generally, if an employee's share of the premium would cost that employee more than 9.5% of his or her annual household income, the coverage isn't considered affordable. There are three safe harbors that employers can use to satisfy the affordability requirement. An employer will avoid a penalty if:

1. The cost of the coverage won't exceed 9.5% of the Form W-2 wages the employer pays the employee that year,
2. The employee's monthly contribution amount for the self-only premium is equal to or lower than 9.5% of the computed monthly wages, or
3. The employee's cost for self-only coverage doesn't exceed 9.5% of the federal poverty line for a single individual.

The affordability test applies to the lowest cost option available to the employee that also meets the minimum value requirement.

Under the minimum value requirement, a health plan must cover at least 60% of the total allowed costs of benefits provided under the plan. A minimum value calculator where employers can enter certain plan information and obtain a determination of whether the plan provides minimum value can be found at CMS.gov. (Simply type "minimum value" into the search field.)

Alternatively, for plans that provide certain benefits within specific deductible, copay and other cost-sharing limits, an employer can comply with certain safe harbors established by the U.S. Department of Health and Human Services and the IRS. For a plan with nonstandard features that are incompatible with the minimum value calculator and the safe harbors, an employer can obtain actuarial certification of minimum value. Or, for a plan in the small group market, an employer can meet the requirements for any of the levels of "metal coverage" (bronze, silver, gold or platinum), which are based on the level of cost-sharing.

Calculating penalties

When one or more full-time employees receive a premium tax credit, the amount of a large employer's penalty will depend on whether it offers minimum essential health care coverage to at least 95% of its full-time employees (and their dependents, defined as an employee's children under age 26). If it *doesn't*, the annual penalty is $2,000 per full-time employee in excess of 30 full-time employees. Note that there's an exception for certain employers that don't meet the 95% requirement but exclude no more than five employees.

If the large employer *does* offer at least 95% of its full-time employees (and their dependents) minimum essential coverage *but* this coverage is deemed not to be affordable or not to provide minimum value, the penalty is the *lesser* of this same penalty or $3,000 for each full-time employee receiving a premium tax credit.

For purposes of penalty calculations, only actual full-time employees are included, not FTEs. Penalties will increase annually based on premium growth.

Moving forward

Some employers may opt to simply pay the penalties because the increased costs due to the broader scope of coverage required may be greater than the penalties. These employers could incur other costs, though, such as lost tax benefits (unlike health care benefits, penalties aren't deductible) and the costs to remain competitive in the labor market. Other employers may consider making adjustments to their workforces in an effort to avoid being considered a large employer. But this may be easier in theory than in practice. (See Case Study I below.)

CASE STUDY I — Cutting hours to avoid "play-or-pay" provision

If you're over, but not too far over, the play-or-pay provision's 50 full-time employee threshold — which includes full-time equivalents (FTEs) — you might be able to make some adjustments to your workforce to avoid hitting the threshold and being at risk for penalties. But it's not as simple as reducing employees' hours and hiring more part-timers.

For example, a grocery store with 40 part-timers who average 90 hours per month would have 30 FTEs (40 × 90 = 3,600; 3,600/120 = 30) who must be added to the number of actual full-time employees (those working at least 130 hours during the month) when determining whether the 50 full-time employee threshold is met. If the store reduced the average hours by half and doubled its part-time workforce in order to cover the same hours, the result would be the same 30 FTEs (80 × 45 hours = 3,600; 3,600/120 = 30).

In other words, when it comes to part-time employees, it's the total number of hours worked by all part-timers that's critical, not the number of part-timers or how many hours each part-timer works.

So before cutting employee hours in an effort to avoid penalties, it's important to look carefully at the extent to which doing so would actually reduce your FTEs — as well as the other ways the reduction would affect your organization.

Changes to the health care coverage credit

While smaller employers don't have to worry about the penalties going into effect in 2015, some do need to be aware of changes to the health care coverage tax credit that take effect in *2014*. And if your organization is eligible for the tax credit but hasn't taken advantage of it, you should consider doing so in 2013 — and see if you can file an amended return to claim the credit for previous years.

The credit through 2013

The health care act provision providing tax credits to qualifying small employers took effect in 2010. Employers with fewer than 25 FTEs and average annual wages of less than $50,000 that pay at least half of the cost of health insurance for their employees may qualify.

Through 2013, the credit for businesses, which reduces income tax liability dollar-for-dollar, is for up to 35% of the cost of group health coverage. For nonprofits, the benefit is a little different. (See "Health care coverage credit differences for nonprofits" below for details.)

Whether business or nonprofit, qualifying organizations with 10 or fewer FTEs and average annual wages of less than $25,000 can claim the maximum applicable credit. Qualifying organizations that exceed either threshold are entitled to partial credits on a sliding scale, and the credit is phased out altogether when an organization reaches 25 FTEs or average annual wages of $50,000.

The number of FTEs is determined slightly differently than for play-or-pay provision purposes, by calculating the total hours of service for which your organization pays wages to employees during the year (but not more than 2,080 for any one employee), and then dividing that figure by 2,080.

CASE STUDY II **Calculating the health care coverage credit**

For the 2013 tax year, Acme offers its employees a group health plan with single and family coverage and pays 50% of the premiums. Acme has 10 full-time equivalent employees with average annual wages of $23,000. Six employees are enrolled in single coverage and four are enrolled in family coverage. Total premiums are $4,000 a year for single coverage and $10,000 a year for family coverage.

Average premiums for the small group market in Acme's state are $5,000 and $12,000, respectively. Acme's premium payments ($2,000 for single coverage and $5,000 for family coverage) don't exceed 50% of these averages, so it computes the credit based on its actual premium payments of $32,000 (6 × $2,000 + 4 × $5,000). Acme's tax credit is $11,200 ($32,000 × 35%).

Only the employer's portion of health insurance premiums counts in calculating the credit. And that amount is further limited to the amount the employer would have paid based on the average premium for the small group market in the employer's state or area, if it's less than the actual premium. (See Case Study II above.)

2014 and later

After 2013, some additional changes to the credit go into effect:

Coverage must be purchased through a state (or federal) exchange. The health care act intended that state governments would establish and run the affordable insurance exchanges, but the federal government agreed to launch and handle them in states that couldn't (or wouldn't) set one up. The federal government may, in fact, end up running about half of the exchanges nationwide. Only qualifying employers that purchase coverage through an exchange will be eligible for the credit.

The maximum credit increases. It can be as much as 50% of a business's contributions toward the health insurance premiums. For nonprofits, the maximum credit becomes 35%.

The credit can be taken for only two years. There is no requirement as to which two years must be chosen. Thus, some planning should be involved in determining when to claim the credit. That is, if the credit will be reduced in a particular year due to one or more of the various limits that apply, the employer may be better off waiting until the next year to see if the credit will be more valuable.

Health care coverage credit differences for nonprofits

The health care coverage credit for small employers is available to qualified small nonprofits, but with some important differences:

- The maximum credit is 25% of qualified costs from 2010 through 2013 and 35% of costs for 2014 and future years.
- Because nonprofits generally don't pay income tax, the credit offsets their withholding tax liability.

The other rules for the credit are generally the same for nonprofits as they are for businesses.

Increased Medicare tax withholding in 2013

Under the Federal Insurance Contributions Act (FICA), wages are subject to a 2.9% Medicare tax — 1.45% paid by the employers and 1.45% withheld from the employees' wages. Under the health care act, starting in 2013, taxpayers with FICA wages over $200,000 per year ($250,000 for joint filers and $125,000 for married filing separately) must pay an additional 0.9% Medicare tax on the excess earnings.

Unlike regular Medicare taxes, the additional Medicare tax *doesn't* include a corresponding employer portion. But employers *are* obligated to withhold the additional tax to the extent that an

employee's wages exceed $200,000 in a calendar year.

Withholding requirements

You aren't required to begin withholding additional Medicare tax until the pay period in which you pay wages in excess of $200,000 to an employee. But the $200,000 threshold applies without regard to the employee's filing status or income from other sources.

So in some cases you'll be required to withhold the tax from wages paid to employees who aren't liable for it — because, for example, their wages, together with those of their spouses, don't exceed the $250,000 threshold for joint filers. In this situation an employee can't ask you to stop withholding the tax. Rather, the employee can recover the tax by claiming a credit on his or her income tax return for the year.

Adjustments and refund claims

It's critical to follow the withholding requirements, because an employer that fails to do so is liable for additional Medicare tax, plus all applicable penalties. If the employee pays the tax, the employer is relieved of liability for the tax but may still be subject to penalties.

You can make interest-free adjustments in the event of underpayments or overpayments of additional Medicare tax compared to your withholding obligations. Generally, this is done by filing the appropriate corrected return (for example, Form 941-X) and reimbursing overpaid amounts to the employee or collecting underpaid amounts from the employee's wages before year end.

Underpayments may be adjusted only if the error occurs during the same year the underlying wages were paid (with certain exceptions, including underpayments attributable to administrative errors or IRS examinations). You're liable for the correct amount of tax, even if you're unable to deduct the underpaid tax from the employee's wages.

Overpayments may be adjusted if you ascertain the error in the year the wages were paid and reimburse the employee for overcollected amounts by year end. If you're unable to reimburse the employee by year end, you shouldn't make an adjustment. Instead, you should report the amount withheld on the employee's W-2 so the employee can obtain a credit on his or her individual income tax return.

You can claim a refund of overpaid additional Medicare tax, provided you *didn't* deduct or withhold the overpaid amounts from the employee's wages.

Can employees request additional Medicare tax withholding?

It's possible that no additional Medicare tax will be withheld from employees who are liable for the tax. This could occur if the combined earnings of a married couple filing jointly exceed $250,000 but neither spouse's wages are more than $200,000 or if an individual has two jobs and neither job pays wages in excess of the threshold.

Employees who anticipate additional Medicare tax liability can't request that you withhold additional amounts specifically for the tax. They can, however, use Form W-4 to request additional income tax withholding sufficient to cover their liability for the additional Medicare tax.

Other changes going into effect in 2013

Some other tax-related health care act provisions go into effect in 2013 that you need to be aware of.

W-2 reporting

A requirement that may already have affected your organization is related to W-2 reporting: Employers that filed 250 or more 2011 W-2 forms must begin reporting the cost of employer-provided health care coverage on the forms beginning with the 2012 tax year — that means the W-2s distributed in January 2013.

As explained in IRS Notice 2011-28, the new requirement calls for informational reporting only — it doesn't cause excludable benefits to become taxable or change the tax treatment in any way. The purpose of the requirement is "to provide useful and comparable consumer information to employees on the cost of their health care coverage."

FSA compliance

Health care Flexible Spending Accounts (FSAs) allow employees to redirect pretax income to an employer-sponsored plan that pays, or reimburses them for, qualified medical expenses not covered by insurance. Through 2012, employers offering health care FSAs had been allowed to set whatever employee contribution limit they wished. But starting in 2013 the maximum limit is $2,500. Employers can set a *lower* limit, however.

According to the IRS, the new limit applies on a plan year basis. Thus, non-calendar-year plans must comply for the plan year that starts in 2013.

Employers will need to amend their plans and summary plan descriptions to reflect the $2,500 limit (or a lower one, if they wish) by Dec. 31, 2014, and institute measures to ensure employees don't elect contributions that exceed the limit. Note that there will continue to be *no* limit on employ*er* contributions to FSAs.