

June 18, 2010

Dear Client:

Earlier this year President Obama signed into law the final piece of his promised Health Reform legislation. No one can argue that this is landmark legislation that will result in a monumental shift in how health care is delivered in this country. Once fully phased in 2018, the legislation provides health care coverage to the uninsured and makes it more affordable 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.

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 employees are assessed excise taxes to discourage them from opting out of coverage.

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. The premium is limited to the average premium for the small group market for each state.

Generally, to qualify for the credit, the employer must pay the same percentage (at least 50%) of all its employees' premiums. However, for 2010 only, an employer can qualify even if it pays differing percentages of different employees' premiums as long 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. Additionally, a family member of any of these individuals is not considered an employee for purposes of the credit.

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.

Figuring the number of FTEs: The number of an employer's FTEs is determined by dividing (1) the total hours for which the employer pays wages to employees during the year (not to exceed 2,080 hours per employee) by (2) 2,080. The result is then rounded to the next lowest whole number.

Illustration: For the 2010 tax year, ABC pays 5 employees wages for 2,080 hours each, one employee wages for 2,300 hours and 3 employees wages for 1,040 hours each.

Total hours not exceeding 2,080 per employee is the sum of:

1. 10,400 hours for the 5 employees paid for 2,080 hours each (5x 2,080);
2. 3,120 hours for the 3 employees paid for 1,040 hours each (3 x 1,040);
3. 2,080 hours for the 1 employee paid for 2,300 hours (lesser of 2,300 or 2,080)

Hours total to 15,600.

ABC has 7 FTEs (15,600/2,080 = 7.5, rounded to the next lowest whole number)

Because the limit on the number of employees is based on FTEs, an employer with 25 or more employees may qualify for the credit if some of the employees are part-time. For example, an employer with 46 half-time employees (i.e., paid wages for 1,040 hours) has 23 FTEs and therefore may qualify for the credit. However, seasonal workers are disregarded in determining FTEs and average annual wages unless they work for the employer on more than 120 days during the tax year.

Calculating average annual wages. The amount of average annual wages is determined by first dividing (1) the total wages paid by the employer to non-excluded employees during the employer's tax year by (2) the number of the employer's FTEs. The result is then rounded down to the nearest \$1,000

Illustration. For the 2010 tax year, XYZ has \$224,000 in wages and has 10 FTEs. XYZ's average annual wages for purposes of the credit are \$22,000 (\$224,000 divided by 10= \$22,400, rounded down to the nearest \$1,000).

The tax credit is reduced for employers that have more than 10 FTEs and average annual wages greater than \$25,000.

Illustration: For the 2010 tax year, Widget, Inc, a qualified employer, has 12 FTEs and average annual wages of \$30,000. Widget pays \$96,000 in health care premiums for those employees.

Widget's credit is \$22,400, calculated as follows:

1. Initial amount of credit before reductions is \$33,600 (\$96,000 x 35%).
2. Credit reduction for FTE's in excess of 10 is \$4,480 (\$33,600 x 2/15).
3. Credit reduction for average annual wages in excess of \$25,000 is \$6,720 (\$33,600 x \$5,000/\$25,000).
4. Total credit reduction is \$11,200 (\$4,480 + \$6,720). Total credit is then \$22,400 (\$33,600 - \$11,200).

Therefore, to compute the amount of the tax credit you will need to have the total hours each employee was paid for during 2010. Additionally, you will need the amount paid in healthcare premiums for your staff during 2010.

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.)

There are other provisions of the new Health Reform Legislation Tax Provision that do not start until 2011, 2012, 2013, 2014 and 2018. These provisions will be addressed at a later date.

Very truly yours,

Proctor Company