7 Things To Know About Employer-Provided Health Insurance

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Benefits Pro

No one agrees on the exact numbers, but it's a safe bet to say that over the next few years millions of Americans will sign up for health insurance on the now-open public exchanges.

Some of those people will have been shifted to the exchanges by mostly smaller employers. But larger employers aren't likely to be part of that wave. In fact, industry analysts say most Americans will continue to get coverage through an employer.

Moreover, even though many small businesses aren't under any obligation to provide health care coverage to employees, nearly two-thirds may do just that in coming years.

That's according to a survey of 532 small businesses designed to elicit their attitudes toward health coverage. Sponsored by small business insurer Employers Holdings Inc., the survey found that two in five small businesses with between one and 250 employees already offer coverage, and another one in five intends to do so within the next three years.

The point is, employer-provided health insurance isn't going away anytime soon.

So, with all of that in mind, here are seven things to know about deductions, credits, what's taxable and more if you're setting up a health insurance plan for your company.

1. May an employer deduct as a business expense the cost of premiums paid for accident and health insurance for employees?

An employer generally can deduct as a business expense all premiums paid for health insurance for one or more employees. This includes premiums for medical expense insurance.

Premiums are deductible by an employer whether coverage is provided under a group policy or under individual policies. The deduction for health insurance is allowable only if benefits are payable to employees or their beneficiaries; it is not allowable if benefits are payable to the employer. Where a spouse of an employer is a bona fide employee and the employer is covered as a family member, the premium is deductible. A corporation can deduct premiums it pays on group hospitalization coverage for commission salespersons, regardless of whether they are employees. Premiums must qualify as additional reasonable compensation to the insured employees.

If a payment is considered made to a fund that is part of an employer plan to provide the benefit, the deduction for amounts paid or accrued may be limited.

An accrual basis employer that provides medical benefits to employees directly instead of through insurance or an intermediary fund may not deduct amounts estimated to be necessary to pay for medical care provided in the year but for which claims have not been filed with the employer by the end of the year if filing a claim is necessary to establish the employer's liability for payment.

2. What credit is available for small employers for employee health insurance expenses?

A credit is available for employee health insurance expenses of an eligible small employer for taxable years beginning after Dec. 31, 2009, provided the employer offers health insurance to its employees.

An eligible small employer is an employer that has no more than 25 full time employees, the average annual wages of whom do not exceed $50,000 (in 2010, 2011, 2012, and 2013; the amount is indexed thereafter).

An employer must have a contribution arrangement for each employee who enrolls in the health plan offered by the employer through an exchange that requires that the employer make a non-elective contribution in an amount equal to a uniform percentage, not less than 50 percent, of the premium cost.

Subject to phase-out based on the number of employees and average wages, the amount of the credit is equal to 50 percent, and 35 percent in the case of tax exempts, of the lesser of (1) the aggregate amount of non-elective contributions made by the employer on behalf of its employees for health insurance premiums for health plans offered by the employer to employees through an exchange, or (2) the aggregate amount of non-elective contributions the employer would have made if each employee had been enrolled in a health plan that had a premium equal to the average premium for the small group market in the ratings area.

For years 2010, 2011, 2012, and 2013, the following modifications apply in determining the amount of the credit:

(1) the credit percentage is reduced to 35 percent (25 percent in the case of tax exempts);

(2) the amount under (1) is determined by reference to non-elective contributions for premiums paid for health insurance, and there is no exchange requirement; and

(3) the amount under (2) is determined by the average premium for the state small group market.

The credit also is allowed against the alternative minimum tax.

In 2014 small employers will have exclusive access to an expanded Small Business Healthcare Tax Credit under the Affordable Care Act. This tax credit covers as much as 50 percent of the employer contribution toward premium costs for eligible employers who have low- to moderate wage workers.

3. Is the value of employer-provided coverage under accident or health insurance taxable income to an employee?

Generally, no.

This includes medical expense and dismemberment and sight loss coverage for the employee, his or her spouse and dependents, and coverage providing for disability income for the employee. There is no specific limit on the amount of employer-provided coverage that may be excluded from an employee's gross income. Coverage is tax-exempt to an employee whether it is provided under a group or individual insurance policy.

Likewise, the value of critical illness coverage is not taxable income to an employee.

Accidental death coverage is excludable from an employee's gross income under IRC Section 106(a).

If an employee pays the premiums on his or her personally-owned medical expense insurance and is reimbursed by his or her employer, the reimbursement likewise is excludable from the employee's gross income under IRC Section 106.

Where an employer simply pays an employee or retiree a sum that may be used to pay the premium but that amount is not required to be used for that purpose, the amount is taxable to the employee.

Under the Patient Protection and Affordable Care Act of 2010 ("PPACA 2010"), the exclusion from gross income for amounts expended on medical care is expanded to include employer provided health coverage for any adult child of the taxpayer if the adult child has not attained the age of 27 as of the end of the taxable year. According to Notice 2010-38, the adult child does not have to be eligible to be claimed as a dependent for tax purposes for this income exclusion to apply.

If an employer's accident and health plan continues to provide coverage pursuant to a collective bargaining agreement for an employee who is laid off, the value of the coverage is excluded from the gross income of the laid-off employee. Terminated employees who receive medical coverage under a medical plan that is part of the former employer's severance plan are considered to be employees for purposes of IRC Sections 105 and 106. Thus, an employer's contributions toward medical care for employees are excludable from income under IRC Section 106. Otherwise, the exclusion is available only to active employees.

4. What are the tax consequences of payments received by employees under employer-provided accident or health insurance?

Although the amounts that both employers and employees pay for premiums for employer sponsored health and accident insurance plans must now be stated on the employee's Form W-2, the tax consequences of receiving benefits pursuant to those plans have not changed. However, some payments must be included in the employee's gross income, explained below.

Amounts received by an employee under employer-provided accident or health insurance, group or individual, that reimburse the employee for hospital, surgical, and other medical expenses incurred for care of the employee or his or her spouse and dependents generally are tax-exempt without limit.

Nonetheless, benefits must be included in gross income to the extent that they reimburse an employee for any expenses that the employee deducted in a prior year. Moreover, if reimbursements exceed actual expenses, the excess must be included in gross income to the extent that it is attributable to employer contributions.

Where an employer reimburses employees for salary reduction contributions applied to the payment of health insurance premiums, these amounts are not excludable under IRC Section 105(b) because there are no employee-paid premiums to reimburse.

Likewise, where an employer applies salary reduction contributions to the payment of health insurance premiums and then pays the amount of the salary reduction to employees regardless of whether the employee incurs expenses for medical care, these so-called advance reimbursements or loans are not excludable from gross income under IRC Section 105(b) and are subject to FICA and FUTA taxes.

Sight Loss and Dismemberment Benefits

Payments not related to absence from work for the permanent loss, or loss of use, of a member or function of a body or permanent disfigurement of the employee or his or spouse or a dependent are excluded from income if the amounts paid are computed with reference to the nature of the injury.

A lump-sum payment for incurable cancer under a group life-and-disability policy qualified for tax exemption under this provision.

Benefits determined by length of service rather than type and severity of injury did not qualify for the exemption.

Benefits determined as a percentage of a disabled employee's salary rather than the nature of the employee's injury were not excludable from income. An employee who has permanently lost a bodily member or function but is working and drawing a salary cannot exclude a portion of that salary as payment for loss of the member or function if that portion was not computed with reference to the loss.

Critical Illness Benefits

Amounts received by an employee under employer-provided critical illness policies where the value of the coverage was not includable in the employee's gross income are includable in the employee's gross income. The exclusion from gross income under IRC Section 105(b) applies only to amounts paid specifically to reimburse medical care expenses. Because critical illness insurance policies pay a benefit irrespective of whether medical expenses are incurred, these amounts are not excludable under IRC Section 105(b).

Wage Continuation and Disability Income

Sick pay, wage continuation payments, and disability income payments, both preretirement and postretirement, generally are fully includable in gross income and taxable to an employee.

Accidental Death Benefit

Accidental death benefits under an employer's plan are received income tax-free by an employee's beneficiary under IRC Section 101(a) as life insurance proceeds payable by reason of the insured's death. Death benefits payable under life insurance contracts issued after December 31, 1984, are excludable only if the contract meets the statutory definition of a life insurance contract in IRC Section 7702.

Survivors' Benefits

Benefits paid to a surviving spouse and dependents under an employer accident and health plan that provided coverage for an employee and the employee's spouse and dependents both before and after retirement, and to the employee's surviving spouse and dependents after the employee's death, are excludable to the extent that they would be if paid to the employees.

5. What nondiscrimination requirements apply to employer provided health insurance plans?

Under PPACA 2010, a group health plan other than a self-insured plan must satisfy the requirements of IRC Section 105(h)(2). More specifically, PPACA 2010 states that rules similar to the rules in IRC Section 105(h)(3) (nondiscriminatory eligibility classifications), Section 105(h)(4) (nondiscriminatory benefits), and Section 105(h)(8)

(certain controlled groups) apply to insured plans. The term highly compensated individual has the meaning given that term by IRC Section 105(h)(5).

An accident or health insurance policy may be an individual or a group policy issued by a licensed insurance company, or an arrangement in the nature of a prepaid health care plan regulated under federal or state law including an HMO. Unless a policy involves shifting of risk to an unrelated third party, a plan will be considered self-insured.

A plan is not considered self-insured merely because prior claims experience is one factor in determining the premium. Furthermore, a policy of a captive insurance company is not considered self-insurance if, for the plan year, premiums paid to a captive insurer by unrelated companies are at least one-half of the total premiums received and the policy is similar to those sold to unrelated companies.

Likewise, a plan that reimburses employees for premiums paid under an insured plan does not have to satisfy nondiscrimination requirements.

6. What nondiscrimination requirements apply to self-insured health plans?

Nondiscrimination requirements apply to self-insured health benefits, although the IRS announced in Notice 2011-1 on Dec. 22, 2010, that compliance with nondiscrimination rules for health insurance plans will be delayed until regulations or other administrative guidance has been issued. This guidance remains pending. The IRS indicated that the guidance will not apply until plan years beginning in specified periods after guidance is issued. Some plans will be grandfathered.

Benefits under a self-insured plan generally are excludable from an employee's gross income. If a self-insured medical expense reimbursement plan or the self-insured part of a partly-insured medical expense reimbursement plan discriminates in favor of highly compensated individuals, certain amounts paid to highly compensated individuals are taxable to them.

A self-insured plan is one in which reimbursement of medical expenses is not provided under a policy of accident and health insurance. According to regulations, a plan underwritten by a cost-plus policy or a policy that, in effect, merely provides administrative or bookkeeping services is considered self-insured.

A medical expense reimbursement plan cannot be implemented retroactively. To allow this would render meaningless the nondiscrimination requirements of IRC Section 105.

A self-insured plan may not discriminate in favor of highly compensated individuals either with respect to eligibility to participate or benefits.

Eligibility

A plan discriminates as to eligibility to participate unless the plan benefits the following:

(1) 70 percent or more of all employees, or 80 percent or more of all the employees who are eligible to benefit under the plan if 70 percent or more of all employees are eligible to benefit under the plan; or

(2) Employees who qualify under a classification set up by the employer and found by the IRS not to be discriminatory in favor of highly compensated individuals.

Excludable Employees

For purposes of these eligibility requirements, an employer may exclude from consideration those employees who:

(1) have not completed three years of service at the beginning of the plan year; years of service during which an individual was ineligible under (2), (3), (4), or (5) below must be counted for this purpose;

(2) have not attained age 25 at the beginning of the plan year;

(3) are part-time or seasonal employees;

(4) are covered by a collective bargaining agreement if health benefits were the subject of good faith bargaining; or

(5) are nonresident aliens with no U.S.-source earned income.

Benefits

A plan discriminates as to benefits unless all benefits provided for participants who are highly compensated individuals are provided for all other participants. Benefits are not available to all participants if some participants become eligible immediately and others after a waiting period. Benefits available to dependents of highly

compensated employees must be equally available to dependents of all other participating employees. The test is applied to benefits subject to reimbursement, rather than to actual benefit payments or claims.

Any maximum limit on the amount of reimbursement must be uniform for all participants and for all dependents, regardless of years of service or age. Further, a plan will be considered discriminatory if the type or amount of benefits subject to reimbursement is offered in proportion to compensation and highly compensated employees are covered by the plan. A plan will not be considered discriminatory in operation merely because highly compensated participants use a broad range of plan benefits to a greater extent than other participants.

An employer's plan will not violate nondiscrimination rules merely because benefits under the plan are offset by benefits paid under a self-insured or insured plan of the employer or of another employer or by benefits paid under Medicare or other federal or state law. A self-insured plan may take into account benefits provided under another plan only to the extent that the benefit is the same under both plans. Benefits provided to a retired employee who was highly compensated must be the same as benefits provided to all other retired participants.

Highly Compensated Individual

An employee is a highly compensated individual if the employee falls into any one of the following three classifications:

(1) The employee is one of the five highest paid officers;

(2) The employee is a shareholder who owns, either actually or constructively through application of the attribution rules more than 10 percent in value of the employer's stock; or

(3) The employee is among the highest paid 25 percent, rounded to the nearest higher whole number, of all employees other than excludable employees who are not participants and not including retired participants. Fiscal year plans may determine compensation on the basis of the calendar year ending in the plan year.

A participant's status as officer or stockholder with respect to a particular benefit is determined at the time when the benefit is provided.

7. What are the tax consequences for amounts paid by an employer to highly compensated employees under a discriminatory self-insured medical expense reimbursement plan?

The taxable amount of payments made to a highly compensated individual from a discriminatory self-insured medical expense reimbursement plan is the excess reimbursement. Two situations produce an excess reimbursement.

The first situation occurs when a benefit is available to a highly compensated individual but not to all other participants, or that otherwise discriminates in favor of highly compensated individuals; the total amount reimbursed under the plan to the employee with respect to that benefit is an excess reimbursement.

The second situation occurs when benefits are available to all other participants and are not otherwise discriminatory and where a plan discriminates as to participation; here, excess reimbursement is determined by multiplying the total amount reimbursed to the highly compensated individual for the plan year by a fraction. The numerator is the total amount reimbursed to all participants who are highly compensated individuals under the plan for the plan year; the denominator is the total amount reimbursed to all employees under the plan for such plan year. In determining the fraction, no account is taken of any reimbursement attributable to a benefit not available to all other participants.

Multiple plans may be designated as a single plan for purposes of satisfying nondiscrimination requirements. An employee who elects to participate in an optional HMO offered by the plan is considered benefited by the plan only if the employer's contributions with respect to the employee are at least equal to what would have been made to the self-insured plan and the HMO is designated, with the self-insured plan, as a single plan. Regulations do not suggest how to determine contributions to a self-insured plan.

Unless a plan provides otherwise, reimbursements will be attributed to the plan year in which payment is made; thus, they will be taxed in an individual's tax year in which a plan year ends.

Amounts reimbursed for medical diagnostic procedures for employees, but not dependents, performed at a facility that provides only medical services are not considered a part of a plan and do not come within these rules requiring nondiscriminatory treatment.

Contributory Plan

Reimbursements attributable to employee contributions are received tax-free, subject to inclusion if the expense was previously deducted. Amounts attributable to employer contributions are determined in the ratio that employer contributions bear to total contributions for the calendar years immediately preceding the year of receipt, up to three years; if a plan has been in effect for less than a year, thensuch determination may be based upon the portion of the

year of receipt preceding the time when the determination is made, or such determination may be made periodically (such as monthly or quarterly) and used throughout the succeeding period. For example, if an employee terminates his services on April 15, 2013, and 2013 is the first year the plan has been in effect, such determination may be based upon the contributions of the employer and the employees during the period beginning with January 1 and ending with April 15, or during the month of March, or during the quarter consisting of January, February, and March.

Withholding

An employer does not have to withhold income tax on an amount paid for any medical care reimbursement made to or for the benefit of an employee under a self-insured medical reimbursement plan within the meaning of IRC Section 105(h)(6).

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