Chapter 7
Health Care Options

Disclosure and Updates

There is no way around this. As you already know the Affordable Care Act has turned things upside down and inside out. Some things remain the same, some things have changed, and some things have yet to change.

There are third-party administrators (TPAs) who assist small businesses (and large businesses) in implementing plans to provide health care reimbursements and to allow for pre-tax deductions of certain expenses. And what makes things exceptionally challenging is that TPAs such as Zane, Base and TASC can disagree (imagine that- lawyers not agreeing). The IRS, DOL, ERISA, ACA and DUH, coupled with all kinds of other agencies both Federally and at the state level have chimed in.

DUH doesn't exist. We were just testing you.

The Watson CPA Group currently endorses TASC headquartered in Madison, Wisconsin (Go Bucky!). Their positions appear to be more in line with our interpretations, their legal team has successfully litigated cases in the past, and frankly their representatives are very talented.

This chapter was last updated **August 12 2014**. Be sure to contact the Watson CPA Group or TASC if you have any questions or concerns about the most recent updates. We are all in for a very long and bumpy ride. Updates can be downloaded in PDF at-

www.watsoncpagroup.com/SubS-Chap7.pdf

Plans

Before we jump into the legalities of each plan for each business entity, let's first discuss the ins and outs of Health Reimbursement Arrangements (Section 105) and Cafeteria Plans (Section 125).

Section 105

Health Reimbursement Arrangements (HRAs), Health Reimbursement Plans (HRPs) and Medical Reimbursement Plans (MRPs) are all the same thing. Some TPAs attempt to repackage the guts of Section 105 under their own moniker for marketing purposes. Technically, Section 105 plans come from 26 CFR 1.105-11 titled Self-Insurance Medical Reimbursement Plan. For the exciting Federal Regulations, here is the link-

www.wcgurl.com/5405

An HRA (which is the most commonly heard name) allows a qualified business owner to deduct 100% of qualified long-term care insurance, out of pocket medical expenses, and several other related expenses. This is a great way for business owners to reduce their tax consequence. The costs of these programs from TASC is about $400 per year. The break-even analysis is-

15% Marginal Rate Break Even	2,667
25% Marginal Rate Break Even	1,600
28% Marginal Rate Break Even	1,429

If you are in the 25% tax bracket, for example, this means you would need $1,600 in recurring medical expenses to break-even with the cost of the Section 105 plan administration.

HRAs are ONLY available to sole proprietors, single-member LLCs and single owner S Corps, unless accompanied by a group health plan that meets minimum essential coverage requirements. This is called an integrated HRA and allowed by the Affordable Care Act, and clarified in IRS Notice 2013-54.

And as you will learn, Section 125 Cafeteria Plans are NOT available to this same group.

Section 125

Flexible Spending Arrangements (FSAs) and Cafeteria Plans are generally interchangeable from a naming convention. However it is listed under 26 U.S. Code Section 125 titled Cafeteria Plans. More exciting code at-

www.wcgurl.com/5406

A lot of people are familiar with Section 125 Cafeteria Plans since most companies offer them for their employees to deduct health insurance premiums, medical expenses and dependent care on a pre-tax basis. There is even an allowance for transportation expenses for certain commuting people. This is a huge savings since you get the tax deduction instantly, and there are no income limitations or thresholds. Here are some numbers that demonstrate the savings-

Medical Expenses	10,000		
Income	**50,000**	**80,000**	**100,000**
Marginal Tax Rate	25%	25%	28%
Savings with Section 125	2,500	2,500	2,800
Deduction on Schedule A	5,000	2,000	0
Savings without Section 125	1,250	500	0
Difference (again, real money)	**1,250**	**2,000**	**2,800**

By deducting the expenses through a Section 125 Cafeteria Plan, your savings are good at lower incomes and huge at larger incomes. However without a Cafeteria Plan you are relegated to deducting medical expenses on Schedule A, and subsequently the first 10% of your income is disallowed and only those medical expenses exceeding 10% of your income are deductible. That explains the difference show above.

Cafeteria Plans are not available to sole proprietors, single member LLCs, partners and S Corporation shareholders who own more than 2% of the company. However, you are entitled to hire your spouse who can enjoy this benefit subject to discrimination testing. Gotta love a good old fashioned loophole.

Administrative Costs

While you can probably administer your own Section 125 Cafeteria Plan, it is probably best left to the experts. Do you really want to keep up with regulations, compliance and filings? Yuck. TASC is our strong recommendation, and their fees are listed below-

Participants	Annual Fee
1-5	600
6-11	900
12-22	1,200

Note- participants are NOT all eligible employees. You only pay for those who are participating in the program.

Use or Lose It

All Cafeteria Plan payments for the prior tax year must be made by February 15, such as a medical procedure performed on December 31 yet billed in January of the following year. And the reimbursement request must be submitted by March 15 (this is a generalization depending on your plan provisions).

However, there is an interesting caveat to the use or lose it system- if you lose the money because you didn't have enough qualified medical expenses, the money is returned to the company as ordinary income. Whereas if you worked for a larger company that you did not own, the money would essentially be lost. But when you own the company the money returns to the company, is taxed (since it was once deducted), and it is yours to use.

Starting in 2014, Cafeteria Plans can either extend reimbursements until March 15 or allow you to rollover $500 to the next year. This is an either/or option within the plan covering all employees (not user selected).

Health Savings Accounts (HSAs)
Individuals and small businesses can make HSA contributions as allowed by a high-deductible health insurance plan. So you cannot have an HSA without a high-deductible plan. This acts very similarly to a Cafeteria Plan since you have an account that offers an instant tax deduction when you make contributions into your account. However, one major difference is that it is not a use it or lose it system- your money can accumulate, and you are allowed to invest it within the provision of the plan.

It is a foregone conclusion that when you get older you'll need more medical attention. When you need a new hip at age 72, you'll be drawing money from somewhere- either your 401k, IRAs or your HSA. So in some regards, your HSA becomes a tax-favorable retirement vehicle.

Dependent care benefits cannot be paid through your HSA, nor can an HSA pay for things like cosmetic surgery, fitness programs, maternity clothes, vitamins, etc.

Contribution limits for 2014 are $3,300 for singles, and $6,550 for family plans plus $1,000 each if you are 55 years or older (catchup).

Sole proprietors, single member LLCs and partners cannot have the company make a direct HSA contribution, yet are still allowed to take the deduction on Form 1040 (more on this in a bit).

Gaming the HSA System
As you understand, HSAs are only available in conjunction with a high deductible health plan. The term high deductible means any policy that exceeds $2,500 for a family plan. As you might not be aware, having kids is expensive. Expensive at birth, and it only gets worse- food, cars, house damage, college, etc. But the birth and post natal care is where you can get some HSA help.

Many people will pick a high deductible plan in their pre-children years. This is great. Max out your HSA each year that you can. When you are ready for a family, switch your insurance to a PPO or some other policy that is more robust and more expensive. This protects you during pregnancy, birth and the first 24 months where costs are the highest. Any out of pocket expenses can paid with your HSA funds. Beauty.

Then, when your family medical costs have stabilized, switch back to the high deductible plan.

Long-Term Care

You can purchase insurance policies that cover qualified long-term care services, and include those premiums when calculating your overall medical deduction. Qualified services include necessary diagnostic, preventative, therapeutic, curing treating, mitigating and rehabilitative services, including maintenance or personal care services. They must be required by a chronically ill person and provided by a licensed health care practitioner.

Big list, but this is referring to your typical nursing home and in-home care services usually reserved for the elderly who are unable to completely care for themselves. And Yes, we will all be there. This is probably the biggest overlooked retirement planning checkbox. Our physical longevity has outpaced our cognitive ability by several years. In other words, our bodies last longer than our minds. Here are the deduction limits for 2014-

Under 40	370
Age 41-50	700
Age 51-60	1,400
Age 61-70	3,720
Over 70	4,660

To deduct long-term care premiums you must have a Section 105 HRA or Section 125 Cafeteria Plan in place.

One Person Show or Husband/Wife Team, S Corporation

Generally speaking, for S Corporations with a single owner and therefore only one employee, the rules haven't changed. Business as usual. Remember, as a shareholder of an S Corp you are also considered an employee. If you hire your spouse or if your spouse is also a shareholder of the S Corp, this strategy blows up because you now have two employees.

Sole proprietors and single member LLCs will handle some of these issues differently, so we'll first tackle the S Corporation owner and how health insurance premiums and all the above-mentioned programs interact.

Health Insurance Premiums*

In **IRS Notice 2008-1** health insurance premiums including dental and vision, paid under individual medical and health insurance plans may be deducted as an "above the line" deduction (as opposed to Itemized Deductions on Schedule A) on your personal tax return if the following conditions are met:

▲ The S-Corp must establish an **Accountable Plan** for the payment of health insurance premiums on behalf of the shareholder.

▲ The S-Corp must either directly pay the premiums for the plan or reimburse the shareholder for the premiums paid. Proper recordkeeping habits must be followed. The Watson CPA Group strongly recommends that the company makes the premium payments directly.

▲ Here's the kicker- premiums paid or reimbursed must be included in Box 1 of the shareholder's W-2. The health insurance premiums are not included in Box 3 Social Security Wages and Box 5 Medicare Wages (thus they are exempt from employment taxes). This might take some payroll coordination, but it certainly is worthwhile.

* Sole proprietors, single member LLCs and partners are treated very similarly without the W-2 angle (see below).

By including the cost of health insurance as wages in Box 1 on your W-2, the S-Corp gets a "wage expense" deduction, which in turn reduces the K-1 income for all shareholders (but each shareholder gets comparable a bump in W-2 income as a part of his or her reasonable salary). On your personal tax return, you will get a dollar for dollar deduction for health insurance premiums paid.

You take this deduction on line 29 of Form 1040. This directly reduces your adjusted gross income, and is not a Schedule A itemized deduction (which is good). **If this procedure is not followed**, the premiums can only be deducted on Schedule A subject to the 10.0% income thresholds for medical expenses (which is not good). The quality and subsequent tax savings of this deduction is similar to the Cafeteria Plan example.

The policy can be in the name of the shareholder yet the S-Corp can make the premium payments directly. Or the shareholder can pay the premiums and be reimbursed- we suggest keeping the paper trail to a minimum and having the company pay directly.

Health Savings Accounts (HSAs)

These are treated similarly to health insurance premiums for the self-employed. Therefore, your company can make the contributions directly into your account, and add the contribution amounts to your W-2, Box 1 only. This in turn is deducted on line 25 of your Form 1040 just like health insurance premiums.

How Health Expenses Reduces Self-Employment Taxes

As mentioned earlier, self-employment taxes and Social Security / Medicare taxes are the same thing. When you pay health insurance and / or make health savings account contributions, this must be reported in Box 1 of your W-2. This income is subject to income taxes, but not Social Security and Medicare taxes since the premiums are not included in Box 3 and 5. And you get a $1 for $1 deduction as well on your personal tax return, so the income is a wash.

But extra savings kick in with the reasonable salary testing. As mentioned, 50% of net income is a jumping off point for a reasonable salary. But what if a big chunk of the 50% is actually health insurance premiums and HSA contributions? Example-

	With Health Insurance	**Without Health Insurance**
Net Income	100,000	100,000
Reasonable Salary at 50%	50,000	50,000
Health Insurance Premiums	12,000	0
HSA Contribution	5,000	0
W-2, Box 1 Income	50,000	50,000
W-2, Box 3 Social Security Income	33,000	50,000
W-2, Box 5 Medicare Income	33,000	50,000
Social Security, Medicare Taxes	**5,049**	**7,650**
Total Savings	**2,601**	

That's real money. In your pocket. Per year!

Section 105 Health Reimbursement Arrangements (HRA)

If you adopt an HRA, the S Corp can reimburse you directly for out of pocket medical expenses including long-term care benefits. This in turn reduces your business income and therefore your K-1 income and therefore your income taxes. Otherwise, to spend $10 on contact solution requires you to pay yourself $13. Silly. Get an HRA. But be careful as illustrated earlier with a 25% marginal tax rate you need $1,600 in out of pocket medical expenses and long-term care premiums (not including medical, dental or vision premiums) for it to be cost effective.

Husband/Wife Team

Not much is different with a husband and wife team operating an S Corporation. However, only one person can be an owner, and that same person can be the only employee. Heads or tails. The owner can obtain family coverage for health care services such as medical, dental and vision including family HSAs, and use the entire amount for computing the tax deduction. There is not a proration or limitation for an S Corporation shareholder with a family plan.

So, while it is not required to make your spouse an employee, it is also not advised since you will unnecessarily put yourself into a multiple employee scenario requiring a Section 125 Cafeteria Plan for these deductions.

Sole Proprietors and Single Member LLCs

As you know, single-member LLCs are disregarded entities meaning that the IRS views them as a sole proprietors. Each state might recognize the difference, but for health care purposes and illustration, we will follow the IRS perspective.

As a sole proprietor you do not earn a salary. There is not a W-2 issued to you. Therefore you take the self-employed health insurance premium tax deduction on Line 29 of Form 1040. But this is not always ideal or the most elegant because of self-employment taxes. Huh? Let's go to the numbers-

Premiums	10,000	
Net Business Income	100,000	
	No HRA Form 1040	**With HRA Schedule C**
Net Business Income	100,000	90,000
SE Tax Deduction (50%)	7,650	6,885
Health Insurance Deduction	10,000	0
Adjusted Gross Income	82,350	83,115
SE Taxes	15,300	13,770
Income Taxes	16,444	16,635
Total Taxes Paid	31,744	30,405
Savings (Real? Yes, real money)	**1,339**	

There's a lot of moving parts here. But two things to note- you pay slightly higher income taxes deducting the premiums on Schedule C, but you pay significantly lower self-employment taxes. If you have $15,000 in premiums, the savings is $2,008. Again, real money in your pocket.

What's the catch? With the IRS there's always a catch. To do this, you must adopt a Section 105 Health Reimbursement Arrangement (HRA), and as mentioned earlier the annual administrative cost is $400. Yet, the benefits exceed the costs. Economists love that scenario and you should too.

As a reminder, if you have an HRA you can lump a bunch more medical expenses including long-term care premiums as deductions to your business. So, the $90,000 figure you see above under Schedule C would decrease, and Yes, your savings would therefore increase. Beauty!

One thing to note. You must have enough business income to cover the cost of the premiums, otherwise they are limited.

Multiple Employees

If you have more than one employee, your world will be much different. Under the Affordable Care Act, or perhaps the Unaffordable Care Act, Section 105 HRAs are out unless you have an integrated HRA as described earlier. The only thing left is a Section 125 Cafeteria Plan (sometimes called Flexible Spending Arrangement or FSA).

If you attempt to reimburse your employees directly for their health insurance premium or provide any type of stipend toward that expense, you are violating IRS, DOL and ACA rules. The fines are big. Your only option is to adopt a Section 125 Cafeteria Plan, or gross up employee wages and pay all kinds of unnecessary taxes.

> **Note**: Section 125 Cafeteria Plans are the middle of some controversy right now. IRS Notice 2013-54 suggests that Cafeteria Plans **cannot** be offered without a group health insurance plan. However, some third-party administrators (TPAs) such as TASC are suggesting otherwise. The Watson CPA Group does not know which way this will go when litigated, so use caution if you decide to implement a Section 125 Cafeteria Plan without group health insurance.
>
> Read TASC's memorandum on the subject.
>
> **www.wcgurl.com/6555**

If you offer group health insurance it also behooves you to adopt a Cafeteria Plan. This allows for the pre-tax deduction of health insurance premiums plus the benefits of flexible spending accounts for out of pocket medical expenses and dependent care benefits.

Remember, owners and partners are not eligible for Cafeteria Plans since they have other options. But this does not preclude you from hiring your spouse to enjoy in these benefits.

Combination Plans

There are advantages to adopting multiple plans, such as a Health Savings Account (HSA) and Section 125 Cafeteria Plan. Or, an HSA and Section 105 Health Reimbursement Arrangement. But there are some rules of course. When you do this, you are essentially creating a limited purpose plan.

Let's make some assumptions- you have $6,000 in your HSA and Junior needs $5,000 in orthodontics. Under the limited purpose plan arrangement, you would pay for the dental expenses through your Section 105 or 125 plan first, leaving your HSA intact. The same holds for $5,000 in Lasik. So, dental and vision expenses would be paid through the Section 105 or 125 plan first. Not required, but more ideal.

However, same scenario, but $5,000 in non-dental or non-vision expenses such as prescriptions. You must use your HSA first. No choice. Priority ordering.

Health Care Summary

Health care options within your small business are challenging. Expensive. Convoluted. What worked today might be wrong tomorrow. All kinds of stuff.

Section 105? 125? HSA? High-Deductible Plans? Reimbursing for health insurance? Hopefully all these elements to your health care options make sense now. If not or if you just want a warm fuzzy “you got it”, please contact the Watson CPA Group for assistance.

And be sure to get your updates. Updates can be downloaded in PDF at-

www.watsoncpagroup.com/SubS-Chap7.pdf