HISCOCK & BARCLAY LLP

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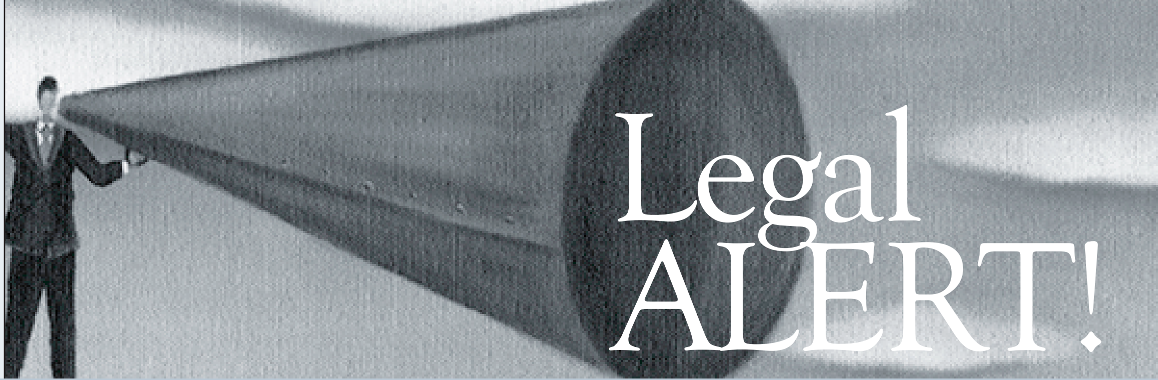

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Health Care Reform Brings Immediate Changes for Employers Now, Bigger Changes Later

On March 23, 2010 President Obama signed into law the first of two bills that will bring about sweeping changes to the nation's health care system (the "Act"). Many of the key elements of the health care overhaul–such as penalties on employers who fail to provide affordable health coverage to employees, and penalties on individuals who decline to purchase coverage–will take effect in 2014 or later. However, a number of provisions take effect now or in 2011. This Alert summarizes health care reform's near-term impact on employers.

Changes Taking Effect Immediately

<u>Small Business Tax Credit.</u> The Act adds a new tax credit to encourage small businesses to offer private health insurance to employees and to pay at least 50 percent of the cost of that coverage. The credit is available only to employers with 25 or fewer full-time equivalent employees ("FTEs") earning an average of $50,000 or less per year. Seasonal employees are not counted for this purpose.

For an employer with 10 or fewer FTEs, the credit is equal to 35 percent of the employer's contribution to the cost of the premium. The credit is phased out for employers with more than 10, but not more than 25 FTEs. If the actual premiums for the coverage exceed a "small business benchmark premium" to be determined by the Federal government, the credit will be computed by reference to the benchmark premium rather than the actual premium. The credit is also reduced if the average compensation of qualifying employer's FTEs exceeds $25,000. The reduction is computed by multiplying the otherwise available credit by a fraction, the numerator of which is the FTE's average compensation in excess of $25,000 and the denominator of which is $25,000.

The credit is not refundable. It may be applied against the employer's alternative minimum tax liability. The credit may be carried back one year and may be carried forward for 20 years.

The credit is available for the years 2010 through 2013. Effective in 2014, the credit will be available only with respect to qualified employers that purchase coverage through a state insurance exchange established under the Act. The credit will increase from 35 percent to 50 percent, and will be available through 2016.

<u>Definition of "Child" to Include Children to Age 26.</u> An employer's deduction for the cost of employee health coverage, including coverage under health Flexible Spending Arrangements ("FSAs"), generally depends on limiting coverage to the employee, the employee's spouse and the employee's dependents. Under pre-Act law, an employee's "dependents" include children, but only up to the age of 19 (24 if the child is a full-time student). Similar definitions apply to the deduction for health insurance for self-employed persons, benefits under voluntary employee benefit associations ("VEBAs"), and retiree health accounts under retirement plans ("401(h) Accounts").

The Act amends the definition of "child" for purposes of the above limitations to include any individual who is the son, daughter, stepson, stepdaughter, or eligible foster child of the taxpayer

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if that individual has not attained age 27 by the end of the taxable year.

> **Hiscock & Barclay Observations.** This change will require employers to revisit and revise their Health FSA and Health Reimbursement Account ("HRA") Plans (e.g. to include FSA reimbursement for medical expenses of children up to age 26 as reimbursable expenses). The change will also require updating COBRA election notices and forms, because attaining age 20 or discontinuing enrollment as a full time student are no longer "qualifying events" under COBRA.

Changes Taking Effect 2011

SIMPLE Cafeteria Plans for Small Employers. Under Pre-Act law, all cafeteria plans are required to meet certain nondiscrimination requirements. In addition, separate nondiscrimination tests apply to each qualifying benefit offered under a cafeteria plan. Beginning in 2011, an eligible small employer that meets certain eligibility and contribution safe harbors will be exempted from all nondiscrimination tests applicable to cafeteria plans and the qualifying benefits offered under the plan.

An eligible small employer means an employer that has employed an average of 100 or fewer employees in either of the two preceding years. A safe harbor plan must generally cover every eligible employee. However, the plan may exclude employees who have not attained age 21, certain nonresident aliens, collectively bargained employees, employees who do not complete 1,000 hours of service in the preceding plan year, and employees who have not completed a year of service at any time during the year. The safe harbor contribution may take the form of a nonelective contribution or a matching contribution. The safe harbor nonelective contribution is two percent of compensation. The safe harbor matching contribution is 100 percent of the employee deferral, up to six percent of compensation.

Cost of OTC Medicines Not Reimbursable under Employer Health Plans. Under pre-Act law, the cost of over-the-counter medications is reimbursable under an employee health plan if the medication is medically necessary. However, for personal income tax purposes, the cost of over-the-counter medications other than insulin is not deductible. This has resulted in preferential tax treatment for the cost of over-the-counter medications paid through an employer health plan.

The Act ends this disparate tax treatment for over-the-counter medications. The Act provides that, effective for expenditures after December 31, 2010, OTC medications are not reimbursable under employer health plans unless prescribed by a physician. This change will apply to Health FSAs, HRAs and Health Savings Accounts ("HSAs") and Archer Medical Savings Accounts ("Archer MSAs").

> **Hiscock & Barclay Observation.** This change will require employers to review their Health FSA and HRA Plans. If the Plans permit reimbursement for over-the-counter medications, the employer will be required to amend the plans effective January 1, 2011 to exclude OTC medications from coverage.

Increase in Additional Tax on Nonqualifying Distributions from HSAs. Employees with high deductible health plans may make tax deductible contributions to a Health Savings Account (HSA). An employer may contribute to the HSA accounts of its employees, including by salary reduction under a cafeteria plan. Disbursements from an HSA to pay qualifying medical expenses are not includable in the account owner's income. Self-employed persons and employees of small employers may obtain many of the advantages of an HSA by establishing an Archer MSA.

Under Pre-Act law, a ten percent penalty tax applies to disbursements from an HSA that are not made to pay qualifying medical expenses. A similar tax applies to nonqualifying withdrawals from an Archer MSA, but the penalty tax rate is 15 percent rather than ten percent. The Act increases the tax rate on nonqualifying disbursements or withdrawals from either account to 20 percent.

Extension of Exclusion for Employer Provided Adoption Assistance. The Act extends the sunset date for exclusion from gross income for employer-provided adoption assistance from December 31, 2010 to December 31, 2011. The Act also increases the amount of assistance that qualifies for the exclusion from $12,170 to $13,170 per eligible child.