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The Department of Treasury recently released final guidance on the health insurance premium tax credit. The proposed regulations issued in August 2011 were discussed in our Reform Update at http://www.mcgrawwentworth.com/Reform_Update/2011/Reform_Update_32.pdf.

The regulations are effective for tax years ending after December 31, 2013, when health care reform will change the insurance market dramatically. In 2014, states or the federal government will establish health insurance exchanges. These exchanges are a new marketplace for individuals or small group health plans to purchase coverage. These exchanges will determine whether applicants are eligible to enroll in qualified health plans.

Advance premium credits or premium tax credits will be available only to eligible low- or moderate-income individuals who purchase individual coverage through the public exchange. Based on a benchmark plan, these credits essentially cap premiums. They are often referred to as premium subsidies.

The final regulations use a number of examples to explain in detail how to determine and manage premium tax credits. The actual text of these regulations is found in the *Federal Register* at http://www.gpo.gov/fdsys/pkg/FR-2012-05-23/pdf/2012-12421.pdf.

Key Definitions

Understanding the key terms listed below is essential to understand the premium assistance process:

- **Qualified Health Plan (QHP):** A health plan offered in the public exchange, excluding "catastrophic" plans defined by health care reform. A catastrophic health plan offers lesser benefits than the metal tiers, and enrollees must be under age 30.
- **Family and Family Size:** Family refers to individuals the taxpayer can properly claim as tax deductions for personal exemptions under Section 151 for the taxable year. Family size refers to the number of individuals in the family.
- **Household Income:** In general, household income is the sum of:
  - A taxpayer's modified adjusted gross income *plus*
  - The combined modified adjusted gross income of all others in the taxpayer's family required to file a tax return.
- **Modified Adjusted Gross Income:** The adjusted gross income plus amounts excluded from gross income under Section 911 (income and benefits earned in other countries and tax-exempt interest a taxpayer receives or accrues during the taxable year).

- **Dependent:** A dependent as defined in Section 152 of the Internal Revenue Code.
- **Federal Poverty Line (FPL):** The most recent poverty guidelines, updated periodically in the *Federal Register*. The FPL that determines premium tax credits is the one in effect on the first day of the initial or annual enrollment period before that taxable year. The FPL is updated annually.

Eligibility for Premium Tax Credit

An applicable taxpayer is allowed a premium tax credit for any month that one or more members of the taxpayer's household:

1. Is enrolled in one or more QHPs through a public exchange.
2. Is not eligible for minimum essential coverage (excludes coverage purchased in the individual insurance market).

Remember that minimum essential coverage can be employer-sponsored coverage, or government-sponsored coverage such as Medicaid, CHIP or Medicare. To be considered minimum essential coverage, an employer plan must pass both the benefits and affordability tests.

An applicable taxpayer is a taxpayer whose household income is at least 100 percent, but not more than 400 percent, of the FPL for the taxpayer's family size for the taxable year. If a taxpayer is married, the taxpayer and spouse must file a joint tax return in order to be considered an applicable taxpayer.

Incarcerated individuals or those not lawfully present in the United States are not eligible to enroll in a QHP (unless the person is incarcerated pending the disposition of charges). Individuals not eligible to enroll in QHPs because of these circumstances could still be applicable taxpayers if a family member is eligible to enroll in a QHP.

The new guidance explains how government programs can be considered minimum essential coverage. First, an individual is considered eligible for government-sponsored minimum essential coverage on the first day of the first full month that he or she qualifies for benefits under the government plan. Keep in mind that simply being eligible for minimum essential coverage can invalidate eligibility for the tax credit, even if an individual does not actually enroll in the plan.

In some situations, the effective dates for government minimum essential coverage can be retroactive. In fact, Medicaid programs commonly implement coverage retroactively. How would that affect the tax credit? In order to simplify administration, the individual will be considered covered under the government's minimum essential coverage as of the first day of the first month following the date coverage is approved. Thus individuals can end their coverage under the exchange once the government coverage goes into effect.

Below are a number of examples clarifying eligibility for the premium assistance:

- **Delayed effective date:** In one example, an individual applies for a government-sponsored health plan on April 10, 2015. Coverage is approved on July 12, 2015, with an effective date of September 1, 2015. As of September 1, the individual is no longer eligible for premium assistance.
- **Medicare eligibility:** An individual turns age 65 on June 3, 2015, and enrolls in Medicare in September, (the last month he or she can enroll). The individual's Medicare benefits are effective on December 1, 2015. As of December 1, the individual is no longer eligible for tax credits.
- **Failure to enroll in Medicare:** Another example assumes all the same facts as in the prior bullet, but the individual does not enroll in Medicare. Remember, if you are eligible for minimum essential coverage, you are not eligible for tax credits. If the taxpayer in the previous example does not enroll in Medicare during the initial enrollment period, the eligibility date is October 1, 2015, the first day of the fourth month following the event establishing eligibility. For Medicare, the enrollment window is the three months before and the three months following the month the person turns age 65. In this case, the October 1 date applies because it is the first day of the month following the end of the enrollment period.
- **Retroactive effective date:** In a final example, an individual works part-time and obtains subsidized coverage in the exchange. The individual loses the part-time job on April 10, 2015, and notifies the exchange. The individual is then determined to be Medicaid-eligible. The application for Medicaid is approved on May 15, 2015, and coverage is made retroactive to April 1, 2015. In this case, premium tax credits are lost on June 1, 2015, the first of the month following the approval for coverage.

Employees and dependents eligible for employer-sponsored coverage are eligible for minimum essential health coverage so long as the employer's plan passes the benefits and affordability tests. Employees and dependents need only be eligible for the coverage, not actually enrolled. Time spent in a new hire waiting period before coverage becomes effective is not considered time when a person is eligible for the plan.

For example, Taxpayer A is an employee of ABC Company. ABC offers minimum essential health coverage during its plan year (October 1 through September 30). All eligible employees can enroll in the plan during annual enrollment in September for an October 1 effective date. Taxpayer A does not enroll in the employer plan. In November 2014, Taxpayer A enrolls in a QHP through the exchange, which is effective January 1, 2015. In this case, Taxpayer A is eligible for employer-sponsored minimum essential coverage. Taxpayer A is ineligible for tax credits from January 1, 2015 through September 31, 2015. Any remaining potential tax credits will be based on the employer's plan benefits and affordability. If the employer makes changes as of October 1, 2015, those changes may affect the benefits or affordability test results.

COBRA coverage is considered minimum essential health coverage only for the months when the individual is enrolled.

The preamble to these final regulations discusses the affordability test in-depth. The required contribution for self-only coverage cannot exceed 9.5 percent of the taxpayer's household income. If the contribution is affordable for single coverage, then any family member eligible under the group health plan is eligible for affordable coverage. Some have asked how this standard can be applied to the entire family, when the affordability measure is based solely on single coverage. The IRS did reserve sections in the regulations to potentially modify these rules. However, as it stands today, affordability is measured on the cost of single coverage.

The new rules maintain the employee "safe harbor." If the exchange determines that the employer-sponsored plan is unaffordable when the employee enrolls in a QHP for the plan year, then the employer plan is considered unaffordable for the entire year. This safe harbor allows employees to keep their tax credits in the exchange and to review the situation again during the employer's next annual enrollment period. It does not apply to people who recklessly disregard the facts and provide incorrect information to the exchange. The taxpayer will have to provide updated information each year so the exchange can determine eligibility for tax credits.

The Commissioner should provide rules for determining how wellness incentives and amounts made available under a health reimbursement arrangement (HRA) should be treated when determining affordability.

To determine affordability for a partial year, annualize the contributions for your employer-sponsored health plan. The annualized contributions are measured against the annual household income.

Here are a few examples on determining affordability:

- **Basic determination:** In 2015, Taxpayer C, an employee of ABC Company, has a household income of $47,000. ABC requires employees to contribute $3,450 for self-only coverage in 2014, which is only 7.3 percent of Taxpayer C's household income. In this situation, employer coverage is affordable. The plan also passes the benefits test. It is considered minimum essential coverage. Therefore, Taxpayer C could qualify for coverage through the exchange, but would **<u>not</u>** be eligible for any tax credits.
- **Exchange determines coverage is unaffordable:** The employer plan year is the same as the calendar year. In November 2013, the exchange determines that Taxpayer D will have a household income of $37,000 in 2014. Taxpayer D is eligible for employer-sponsored coverage, but the annual employee contribution for single coverage is $3,700. Because this amount is 10 percent of Taxpayer D's household income, the plan is not considered affordable. Taxpayer D elects a QHP and is eligible for premium tax credits. In December 2014, Taxpayer D is paid a $2,500 bonus. With this added income, the employee's single contribution for employer coverage is now 9.4 percent of household income. In this situation, the bonus does not change the fact that coverage was considered unaffordable for the 2014 plan year. Thus, Taxpayer D is allowed tax credits for all of 2014.
- **Exchange determines that coverage is unaffordable for the plan year:** This example uses the same facts as in the previous example, but the employer's plan year is September 1 through August 31. In this situation, the exchange will determine that the plan is unaffordable in August. Taxpayer D is considered ineligible for minimum essential

coverage from September 1, 2014 through August 31, 2015. The premium tax credits will be pro-rated for the eligible months in 2014 and 2015.

- **Exchange determines coverage is unaffordable for part of plan year:** The employer's plan year is again September 1 through August 31. A new hire, Taxpayer E, becomes eligible for employer coverage as of May 1, 2015. Taxpayer E's household income is $18,000. The employee's contribution for self-only coverage is $1,800, annualized, which is 10 percent of Taxpayer E's household income. Taxpayer E is not eligible for minimum essential coverage for May 1 through August 31 and will be eligible for tax credits in the exchange. The situation will have to be revisited in August, when the employer makes plan changes for September 1, 2015 through August 31, 2016. The measure of affordability will then be re-determined.
- **Coverage is unaffordable at year's end:** The exchange determines that Taxpayer F is eligible for affordable coverage through his employer in 2015. Taxpayer F decides to purchase coverage in the exchange anyway, even though he is ineligible for tax credits. At the end of the year, his household income is less than expected, and subsequently his employer-sponsored coverage was unaffordable in 2015. Taxpayer F was not eligible for minimum essential coverage in 2015. He can apply for the tax credits when he files his tax return.

Anyone enrolled in an employer-sponsored plan, even if the plan does not pass the affordability and benefits tests, is considered to have minimum essential coverage. This situation brings up a significant concern about auto-enrollment. What if an employer auto-enrolls employees in a plan that does not pass the affordability or the benefits tests? Will this bar employees from being eligible for tax credits?

Employees or their relatives are not treated as enrolled in an employer-sponsored health plan for any month in which they were auto-enrolled in the plan. However, this rule only applies if they terminate coverage before the later of either the first day of the second full calendar month of coverage or the last day of the plan's permitted opt-out period, as required by the Department of Labor.

Computing the Premium Tax Credit

A taxpayer's premium assistance credit applies to everyone in the taxpayer's family for all coverage months during the taxable year. The calculation can get complicated. The following are key definitions related to the tax credit calculation:

- **Cost of QHP:** The QHP premium.
- **Coverage Family:** The taxpayer's family members who enroll in a QHP and are not eligible for minimum essential coverage (other than coverage provided in the individual market).
- **Coverage Month:** A month is a coverage month for an individual if:
    1. As of the first day of the month the individual is enrolled in a QHP through the exchange.

2. The taxpayer pays his or her share of the monthly premium for the individual's coverage by the un-extended due date for filing a tax return for that taxable year, or the full premium is paid by advance tax credit payments.
3. The individual is not eligible for minimum essential coverage during the full calendar month.

Premiums paid by someone other than the taxpayer are treated as if they were paid by the taxpayer.

The examples below detail how the premium tax credit is computed:

- Taxpayer J is single with no dependents. In December 2013, Taxpayer J enrolls for a QHP for 2014. The exchange approves advance premium credits, and he pays his premium on time. On May 15, 2014, Taxpayer J enlists in the U.S. Army. He is immediately eligible for government-sponsored minimum essential coverage. Therefore, Taxpayer J receives premium assistance credit only from January through May.
- Taxpayer L has one dependent, K, eligible for government-sponsored minimum essential health coverage. Taxpayer L enrolls for single coverage in a QHP for 2014 and qualifies for advance premium credits. In August, K loses his government-sponsored coverage. Taxpayer L terminates coverage, in order to enroll his son and himself in a plan that can cover them both. Taxpayer L is still eligible for advance premium credits. In this situation, the premium credits from January through July are based only on Taxpayer L's coverage. From August through December, the credits are based on the two-person coverage. This example assumes Taxpayer L pays all premiums on time.

The premium assistance amount for a coverage month is the lesser of:

1. The monthly premiums for one or more QHPs in which a taxpayer or a taxpayer's family member is enrolled.
2. The amount of the adjusted monthly premium for the applicable benchmark plan (the second-lowest-cost silver plan). Simply put, health care reform caps the premium, based on a percentage of household income and the premium of the benchmark plan. If, based on income, the premium is capped at 6 percent of the monthly household income, then the premium credit is the premium for the benchmark plan that exceeds the 6 percent cap.

The actual premium used is the adjusted monthly premium, which is the premium an insurance carrier would charge, based on the age of each covered family member for the applicable benchmark plan. The adjusted premium does not take into account any premium discounts or rebates for wellness programs or any increased premiums for smokers. This is an important point. Carriers in the exchange can increase rates up to 50 percent for tobacco users. These additional rates will not be covered in the premium assistance amounts. Smokers will be directly responsible for those additional premium amounts.

The applicable benchmark plan for each coverage month is the second lowest cost silver plan offered through the exchange in the rating area where the taxpayer resides. If any plan in the exchange is closed to enrollment at the time a taxpayer enrolls for coverage, then that plan is not used to determine the benchmark plan.

The regulations offer a number of examples for determining the benchmark plan:

- **Single taxpayer enrolls:** An individual with no dependents enrolls in a QHP through the exchange. The benchmark plan is the second-lowest-cost silver plan that can provide self-only coverage to this individual.
- **Three-person family enrolls:** The individual, his or her spouse and their child enroll in a QHP through the exchange. The benchmark plan is the second-lowest-cost silver plan that can cover all three family members.
- **Single taxpayer enrolls with non-dependents:** A man enrolls with his daughter. The man, however, does not claim the daughter as a tax dependent. In this case, the benchmark plan is the second-lowest-cost silver plan that covers just him. If she is eligible, the daughter may qualify for the premium tax credit on her own tax return.
- **Mid-year change in family status:** A single woman enrolls for coverage for 2014. On August 1, she has a child and enrolls for two-person coverage in a QHP through the exchange. In this case, the applicable benchmark plan for January through July is the second-lowest-cost silver plan for individual coverage only. From August through December, however, the benchmark plan is the second-lowest-cost silver plan that can cover the both the woman and her child.

To determine the taxpayer's portion of the premium, multiply the applicable percentage by the taxpayer's household income. The government provides initial and final percentages for a range of household incomes and their relationship to the FPL. The applicable percentage is based on where the income lies in the FPL percentage range which then ties to a percentage between the initial and final percentages:

Household Income Percentage of the FPL	Initial Percentage	Final Percentage
At least 133% but less than 150%	3%	4%
At least 150% but less than 200%	4%	6.3%
At least 200% but less than 250%	6.3%	8.05%
At least 250% but less than 300%	8.05%	9.5%
At least 300% but less than 400%	9.5%	9.5%

For example, a person who earns 141.5 percent of the FPL will have a percentage cap of roughly 3.5 percent, which is exactly between the initial and final percentages for his or her income, relative to FPL.

Reconciling the Premium Tax Credit

The premium tax credit depends on the taxpayer's household income and household size for the taxable year. Taxpayers must reconcile the advance premium credits they received during the year with the credit amount they are actually allowed. If the premium tax credit for the taxable year exceeds the taxpayer's advanced premium credits, then the taxpayer may receive an income tax refund. If, however, the advanced premium credits received for the taxable year exceed the taxpayer's premium tax credit, then the taxpayer pays additional taxes.

Limits on the additional tax owed vary depending on household income. The amount takes into account the FPL and how an individual's taxes are calculated. The caps on additional tax liability range from $300 to $2,500.

Below are examples of the reconciliation process:

- Taxpayer A is single with no dependents. The exchange projects her household income to be $27,925 for 2014, 250 percent of the FPL. Taxpayer A enrolls in a QHP. The annual premium for the applicable benchmark plan is $5,200. Her premium is capped at 8.05 percent of household income, or $2,248. Taxpayer A receives $2,952 in advance credit payments to offset premiums during the year.

  When Taxpayer A files her taxes for 2014, her household income ends up being $33,622. This amount is 301 percent of the FPL for a single person. The premium cap at 301 percent of the FPL is 9.5 percent. Taxpayer A needs to reconcile these differences in her taxes at year's end. The result is that the premium cap is $3,194, which is higher due to year-end earnings. The benchmark plan's premium is still $5,200, which means the eligible tax credit is actually $2,006. Taxpayer A received advance credits of $2,952. The overpayment is $946. Based on her tax situation, the maximum reimbursement is $1,250. Taxpayer A must therefore repay the full $946 when filing her 2014 tax return.
- In this example, the facts are the same as above, but with one change. At the end of 2014, Taxpayer A's household income is $22,430, which is less than anticipated. This is 200 percent of the FPL for a single-person household. Premiums are capped at 6.3 percent of the household income, or $1,407. After subtracting that amount from the $5,200 premium for the benchmark plan, the tax credit for 2014 should be $3,793. Taxpayer A only took $2,952 in advance credit payments. Thus, she is allowed an additional tax credit of $841.
- Taxpayers B and C are married and have two children, K (age 17) and L (age 20). The exchange projects that their 2014 household income will be $63,388, which is 275 percent of the FPL for a family of four. Premium contributions are capped at 8.78 percent of the household income, or $5,565. Taxpayers B and C enroll in a QHP for 2014 that covers both children. The benchmark plan's premium for all four is $14,100. The advance premium credits will be $8,535.

  When Taxpayers B and C file their joint tax return for 2014, they do not claim L as a dependent. The family size is thus reduced from four to three members. Their income of $63,388 is 332 percent of the FPL for a family of three. The premium cap at that level is 9.5 percent of household income. The premium cap for the benchmark plan now becomes $6,022, and the premium credit allowed for 2014 is $5,978 ($14,100 minus $6,022). Taxpayers B and C already collected advanced premiums credits of $8,535, a difference of $2,557. This amount exceeds the reimbursement cap of $2,500 that would apply in this situation. Therefore, Taxpayers B and C have an additional tax liability of $2,500.

Calculating mid-year changes in taxpayer filing status is also fairly complex. For example, if a couple marries during the year, taxes for the time spent single and the time spent married require separate calculations. Since the couple will file a joint tax return for the year, their time spent single is calculated separately and then added for tax purposes. For the married months, the couple's situation is calculated jointly.

If taxpayers divorce during the year, the tax filing is similar. They need to determine, however, how the married credits will be allocated between them. For example, they may prefer that the married credits be allocated proportionally based on household earnings. If the taxpayers cannot agree on the allocation, 50 percent of the premiums for the benchmark plan and 50 percent of the advanced premium credits will be allocated to each taxpayer. If only one of the previously married taxpayers is covered through the exchange and is receiving premium credits, then the entire amount is credited only to that taxpayer at year's end.

Married couples must file joint tax returns to be eligible to receive advance premium credits. These credits will generally be received during the year, and taxes are filed by April 15 of following year. What happens if married taxpayers file separate returns after the fact? Any advance premium credits received will be allocated at 50 percent between the taxpayers. In addition, the reconciliation rules apply separately to each taxpayer. Thus the repayment limits will apply to each taxpayer separately.

Information Reporting by Exchanges

Each year exchanges must report to both the IRS and the taxpayer the following information on the taxpayer's or a family member's qualified health plan:

1. The premium for the applicable benchmark plans used to compute advanced premium credits and the period that coverage was in effect.
2. The total gross premium (without the reduction for premium credits).
3. The total amount of any advanced premium credits paid.
4. The name and Social Security number of the primary insured and the same information for anyone else the plan covers.
5. All information the taxpayer gave the exchange when he or she enrolled and any information on mid-year changes.
6. Any other information the IRS may require.

The guidance will give a time frame for providing this information.

Any taxpayer who received or wants to claim premium tax credits for a given year must file a tax return on or before April 15 of the following year.

Concluding Thoughts

These final regulations on the premium tax credits provide a great deal of information on calculating the credits. One area of special concern is measuring affordability of single-only coverage as a percentage of household income. The preamble to these rules debates this issue at length. The IRS did not make any changes in determining affordability. However, it did leave several sections reserved to deal with this topic.

Employers considering exiting the health benefits business may want to consider the impact this decision will have on employees. The focus has been on whether the employees will be able to use the exchange and make their own health plan decisions. Now employers need to consider the impact on the tax filing process. The process for reconciling advance premium credits with the actual credits permitted at year-end looks straightforward. It becomes more complex as individuals have mid-year family status changes. In addition, if the advance premium credits exceed the tax credit allowed at year's end, taxpayers will be required to repay the difference. Although limits apply to the repayment amounts, they can still be a substantial, unexpected expense.

These rules have minimal direct impact on employers. However, driving employees to use the exchange or terminating the health plan altogether will complicate the insurance purchasing process and year-end tax filing for employees.