



## CHILDCARE SOLUTIONS

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## Health Reimbursement Arrangements (HRA) As a Tax Free Employee Benefit

Internal Revenue Service  
Department of the U.S. Department of Treasury  
Publication 969 – Household Employees  
Publication 502 – Qualified Medical Expenses  
Publication 15-B – Qualified Plans, Expenses and Requirements



## ***Are there any tax breaks if I offer health insurance?***

see: IRS Publication 969

**Yes. And they can be significant for both you and your employee.**

When a household employer contributes toward health insurance premiums, these dollars are not considered taxable income. Neither employer nor employee is required to pay taxes on these dollars. A family may choose to pay the healthcare premium directly to the health insurance company or give these dollars directly to their employee. (In the latter case, the family must keep a copy of a current health insurance card on file for proof of a current insurance policy)

## ***The nanny I'm about to hire would like to have Health Insurance as part of her compensation package. How does that work?***

Health insurance premiums are a non-taxable form of compensation, meaning neither you nor your nanny would have any taxes on that portion of her compensation. Therefore, there is a significant financial advantage to both of you if part of your compensation to her goes toward a health insurance premium.

Here's how the tax math works. Let's say you pay your employee \$2,000 per month in "straight" (taxable) wages. Her "take-home pay" after taxes would be roughly \$1,700 per month (it may be a few dollars higher or lower depending on her personal tax situation). If she then buys a health insurance policy and pays \$300 per month, her after-tax "disposable" income is \$1,400 per month.

Alternatively, if you pay the same \$2,000 per month, but it includes the health insurance contribution (i.e. \$1,700 in taxable wages plus \$300 in health insurance contributions), her after-tax disposable income is \$1,475 per month.

So, in this illustration, your nanny sees a real gain of \$75 per month (or \$900 per year) and your employer taxes are reduced by about \$25 per month (or \$300 per year) – simply by having healthcare contributions managed through the payroll process. It's a win-win situation.

## ***Why can't my nanny just pay for her own health insurance policy and then deduct the premium expense on her itemized tax return?***

The nanny would not receive \$900 per year in a tax refund if she paid for health insurance premiums with after-tax dollars. This option does not exist. She is only \$900 richer if the health insurance premiums are separated from her taxable wages and she is taxed on a smaller amount of wages. She does not have the option of paying for health insurance premiums with after tax dollars (as shown in the first part of the example) and then taking a refund equal to the amount of tax on the dollars used for health insurance premiums. The law (as of 2007) states that health insurance premiums paid by an individual must be paid with after-tax dollars.



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## **New Health Insurance Tax Credit for Nanny Employers**

The IRS recently published the details of the new Health Insurance Tax Credit for Small Employers, which includes households.

If an employer contributes to their employee's health insurance, they will receive up to a 35% tax credit on those contributions. So, in addition to health insurance being non-taxable to families and nannies, it now comes with added savings for families. This tax credit will take effect starting with the 2010 tax year, so this year's contributions will be applicable.

Example: The Smiths paid their nanny \$25,000 during 2010 and also contributed \$300 per month (\$3,600 total) toward her health insurance. The Smiths' 2010 tax credit will be \$1,260 ( $\$3,600 \times 35\%$ ).

### Qualification details:

The employer must pay at least 50% of the premium cost;

The average annual wages paid by the employer (to all employees on staff) must be \$50,000 or less.

**Only an employer can contribute tax-free.**

If a nanny pays for health insurance on her own without assistance from her employer, she must have her entire monthly salary taxed and then pay for health insurance as an after-tax expense. She will not receive a refund or write-off on her health insurance premiums. Therefore, **the only way to generate savings on health insurance premiums is by having the employer provide the dollars for this expense.** Employers can contribute to health insurance premiums tax-free. This can be done by providing money for premiums over and above the salary, which is a significant financial benefit.

In our example, the employer is not increasing their cost by providing health insurance, but they are saving their nanny \$900 per year by reducing her salary by the amount of the health insurance premiums. If the nanny was going to pay \$300 per month for health insurance in any event, she might as well pay for it with pre-tax dollars provided by her employer rather than after-tax dollars on her own. The \$900 savings is generated by taxing a lower monthly gross income (\$1700 vs. \$2000). The nanny increases her net pay by \$75 per month in receiving \$300 from her employer tax-free to use toward health insurance premiums.

This is the only way to receive a tax savings on health insurance premiums. When she is taxed on the full \$2000, she pays taxes on the \$300 used for health insurance premiums. Uncle Sam is not holding a tax refund - she owes the \$900 in taxes as she has higher taxable wages (\$2000 vs. \$1700).

If you have any questions about health insurance or how to set it up so you can take advantage of these tax breaks, call [Breedlove & Associates](#). Breedlove is happy to provide a complimentary phone consultation and guide you through all the financial and legal aspects of being a household employer.

## Health Reimbursement Arrangements (HRAs)

A health reimbursement arrangement (HRA) must be funded solely by an employer. The contribution cannot be paid through a voluntary salary reduction agreement on the part of an employee. Employees are reimbursed tax free for qualified medical expenses up to a maximum dollar amount for a coverage period. An HRA may be offered with other health plans, including FSAs.

**What are the benefits of an HRA?** You may enjoy several benefits from having an HRA.

- **Contributions made by your employer can be excluded from your gross income.**
- **Reimbursements may be tax free if you pay qualified medical expenses. See *Qualified medical expenses*, later.**
- Any unused amounts in the HRA can be carried forward for reimbursements in later years.

### ***Qualifying for an HRA***

HRAs are employer-established benefit plans. These may be offered in conjunction with other employer-provided health benefits. Employers have complete flexibility to offer various combinations of benefits in designing their plan. You do not have to be covered under any other health care plan to participate.

Self-employed persons are not eligible for an HRA.

### ***Contributions to an HRA***

HRAs are funded solely through employer contributions and may not be funded through employee salary deferrals under a cafeteria plan. These contributions are not included in the employee's income. You do not pay federal income taxes or employment taxes on amounts your employer contributes to the HRA.

### **Amount of Contribution**

There is no limit on the amount of money your employer can contribute to the accounts. Additionally, the maximum reimbursement amount credited under the HRA in the future may be increased or decreased by amounts not previously used. See *Balance in an HRA*, later.

### ***Distributions From an HRA***

Generally, distributions from an HRA must be paid to reimburse you for qualified medical expenses you have incurred. The expense must have been incurred on or after the date you are enrolled in the HRA.

Reimbursements under an HRA can be made to the following persons.

1. Current and former employees.
2. Spouses and dependents of those employees.
3. Any person you could have claimed as a dependent on your return except that:
  - a. The person filed a joint return,
  - b. The person had gross income of \$3,400 or more, or
  - c. You, or your spouse if filing jointly, could be claimed as a dependent on someone else's 2007 return.
4. Spouses and dependents of deceased employees.

### **Qualified medical expenses.**

Qualified medical expenses are those specified in the plan that would generally qualify for the medical and dental expenses deduction. These are explained in Publication 502, *Medical and Dental Expenses*. However, even though non-prescription medicines (other than insulin) do not qualify for the medical and dental expenses deduction, they do qualify as expenses for HRA purposes.

Qualified medical expenses from your HRA include the following.

- **Amounts paid for health insurance premiums.**
- Amounts paid for long-term care coverage.
- Amounts that are not covered under another health plan.



**IRS Publication 502 – excerpt**  
**Qualified Medical Expenses**

Insurance Premiums

You can include in medical expenses insurance premiums you pay for policies that cover medical care. Policies can provide payment for:

- Hospitalization, surgical fees, X-rays, etc.,
- Prescription drugs,
- Dental Care,
- Replacement of lost or damaged contact lenses,
- Membership in an association that gives cooperative or so-called “free-choice” medical service, or group Hospitalization and clinical care, or,
- Qualified long-term care insurance contracts (subject to additional limitations). See *Qualified Long-Term Care*, later.

**IRS Publication 15-B – excerpt**  
**Special Rules for Various Types of Fringe Benefits**

<b>Type of Fringe Benefit</b>	<b>Income Tax Withholding</b>	<b>SSI &amp; Medicare</b>	<b>FUTA</b>
Accident and Health Benefits	Exempt	Exempt	Exempt

**Accident or health plan.** This is an arrangement that provides benefits for your employees, their spouses, and their dependents in the event of personal injury or sickness. **The plan may be insured or noninsured and does not need to be in writing.**

**Employee.** For this exclusion, treat the following individual as employees.

- A current common-law employee.
- A former employee you maintain coverage for based on the employment relationship.

## **HOUSEHOLD EMPLOYER DEDUCTIBILITY OF HEALTH INSURANCE PREMIUMS PAID ON BEHALF OF, OR REIMBURSED TO, HOUSEHOLD EMPLOYEES**

### ***CCH (Commerce Clearinghouse) Payroll Guide Section 631, Benefit Plan Contributions***

EMPLOYER CONTRIBUTIONS TO QUALIFIED PLANS ARE GENERALLY NOT TAXABLE

Employer contributions to fund employee benefit plans (retirement and pension plans, group term life insurance up to \$50,000, disability insurance, health and medical insurance, income replacement programs, death and dismemberment insurance, and workers' compensation) are not subject to employment taxes. The plans must be qualified and non-discriminatory as defined in the Internal Revenue Code (.15).

### ***CCH Payroll Guide Section 690, Insurance (Health and Medical)***

EMPLOYER CONTRIBUTIONS FOR MEDICAL INSURANCE PLANS ARE NOT SUBJECT TO EMPLOYMENT TAXES

Payments made to or for the benefit of an employee under a self-insured medical expense reimbursement plan are not subject to FICA, FUTA or Federal Income Tax withholding (.01). A medical reimbursement plan, underwritten by an insurance policy issued by a licensed insurance company, or a qualified prepaid health care plan that does not involve the shifting of risk, is "self-insured."

### ***CCH Perk Tax Guide Section 4378***

WHAT IS THE TAX EFFECT ON THE EMPLOYEE WHEN PREMIUMS ARE PAID

An employer's contribution to a health and accident plan that provides sickness, injury, or preventative health benefits, including diagnostic medical surveillance benefits for its employees, their spouses, or their dependents is not taxable to the employees.

### ***CCH Perk Tax Guide Section 4364***

WHAT ARE THE ADVANTAGES FOR THE EMPLOYEE?

Health insurance may be provided to employees on a tax-free basis. No amount is required to be included in the employee's income or wages at the time the employer makes contributions to the plan or pays premiums to the insurance company, and no amount is required to be included when benefits are paid to the employee to the extent that the benefits do not exceed the employee's medical care expenses