farmdoc DAILY

Department of Agricultural and Consumer Economics, University of Illinois Urbana-Champaign

Farmers and Small Farms Can Maximize Tax Savings from Health Insurance Costs

Marc Lovell

Tax School and Department of Agricultural and Consumer Economics
University of Illinois

September 24, 2014

***farmdoc daily* (4):184**

Recommended citation format: Lovell, M. "Farmers and Small Farms Can Maximize Tax Savings from Health Insurance Costs." *farmdoc daily* (4):184, Department of Agricultural and Consumer Economics, University of Illinois at Urbana-Champaign, September 24, 2014.

Permalink URL
http://farmdocdaily.illinois.edu/2014/09/farmers-and-small-farms-maximize-tax-savings-from-health-costs.html

Under the Affordable Care Act (ACA), the individual mandate requires farmers to obtain and maintain "minimum essential coverage" (MEC) for themselves and dependents.[1] Because of the many changes associated with the ACA, many farmers and farm businesses may be paying health insurance premiums for the first time in 2014 or may have faced increased premiums to comply with the ACA mandates. Accordingly, many farmers may find it helpful to understand some useful tax rules associated with the deduction of health insurance premiums.

Self-Employed Health Insurance Deduction

Under the Tax Code, the self-employed farmer may claim a deduction for health insurance costs. Premiums deductible include premiums paid for:[2]

- The farmer
- The farmer's spouse
- Dependents of the farmer, and
- The farmer's child, stepchild, adopted child or eligible foster child who has not reached age 27 by the end of the year (even if the child was not a dependent of the farmer).

The farmer may qualify for the self-employed health insurance deduction if an **initial test** is met and if the health plan is **established under the farmer's business**. Moreover, the farmer must **not have been eligible** to participate in any subsidized health plan of an employer.

[1] IRC sec. 5000A(a).
[2] IRC sec. 162(l)(1); IRC sec. 152(f)(1)(A),(B), (C).

Initial Test

In order to qualify for this deduction, the farmer must meet any one of the following requirements:

- The farmer must have net farm profit on Schedule F (or other self-employment profit)
- The farmer used one of the optional methods (such as the farm optional method) on Schedule SE, *Self-Employment Tax*, to calculate net self-employment (SE) earnings
- The farmer is a partner in a partnership who has net SE earnings shown in box 14 of Schedule K-1 that accompanies the farmer's partnership return
- The farmer is an S corporation shareholder who owns more than 2% of the stock in the S corporation and has received a Form W-2, *Wage and Tax Statement* that shows health insurance premiums paid or reimbursed by the S corporation.

Note: Further information on the optional methods of calculating SE earnings, such as the nonfarm method, farm method and the use of both methods for farmers who have both farming and nonfarming income may be found in IRS Publication 334, Tax Guide for Small Businesses.

Health Plan Established Under the Farmer's Business

In addition, the health insurance plan must be **established** (or considered to be established) **under the business**. The business under with the health insurance plan is established may be a farm or nonfarm business. This test may be met under the following rules.

- For the self-employed farmer, the health insurance policy can be in the name of the farm business (or a nonfarm business of the farmer) or in the farmer's name.

- For farmers who are partners, the health insurance plan may be in the name of either the partnership or the farmer. The premiums may be paid by either the partnership or the farmer, but if the policy is in the farmer's name and the farmer pays the premiums personally, the partnership must reimburse the farmer. In addition, regardless whether the partnership or the farmer pays the premiums, the farmer must report the premium amounts as a guaranteed payment. These premium amounts must appear on Schedule K-1 and will be included in the farmer's gross income for tax purposes. Otherwise, the health insurance plan will not be considered to be established under the farmer's business.[1]

- For a farmer who owns more than 2% of the stock in an S corporation, the health insurance policy may be in the name of either the S corporation or the farmer. Either the farmer or the S corporation may pay the premiums. If the policy is in the farmer's name and the farmer pays the premiums, the S corporation must reimburse the farmer for the premiums that the farmer paid. Regardless whether the farmer or the S corporation paid the premiums, the premium amounts must be included as wages on the farmer's Form W-2. Otherwise, the health insurance plan will not be considered to be established under the farmer's business.[2]

For the farmer with an S corporation, the health insurance premiums that are included in wages are subject to income tax withholding, but are not subject to social security or Medicare taxes. However, premiums treated as partnership guaranteed payments are subject to income tax, social security and Medicare taxes.

Farmer Must Not Have Been Eligible for Employer Coverage

[1] See IRS Pub. 535, *Business Expenses* for additional information.
[2] IRS Notice 2008-1, 2008-2 IRB 251.

In addition, the farmer does not qualify for the self-employed health insurance deduction for any month during the year that the farmer was eligible to participate under an employer's subsidized health plan. This includes such a plan offered by an employer of the farmer, the farmer's spouse or a dependent of the farmer in which the farmer was eligible to participate.[1]

Additional Rules on Calculating the Deduction

It is important to clearly document and identify that the health plan is "established under the business". For farmers with multiple farm businesses, documenting which business under which the health plan is established is important because the amount of the deduction for health insurance premiums is limited by the amount of SE income earned from that business.[2] The farmer cannot add the net profits of all businesses to arrive at an increased limit for the deduction of health premiums. However, if the farmer has more than one plan, each established under its respective farm or nonfarm business, the farmer may deduct the insurance premiums of each plan up to the net earnings of the farm or nonfarm business under which each plan is established.[3] Generally, the amount of SE income is the net income from the farm or nonfarm business under which the plan is established minus the deductible part of any SE tax the farmer has paid in connection with that business.

Relationship Between the Deduction and the Premium Assistance Credit Under the ACA

Farmers that obtain coverage through the Marketplace exchange may qualify for the Premium Assistance Credit (PAC) if the farmer's household income is between 100% and 400% of the federal poverty guideline.

Note. The federal poverty guideline income amount varies depending upon the number of persons in the farmer's household. For a review of the federal poverty guideline amounts for 2014 and details on the PAC, see the September 12, 2014 farmdoc daily article.

Generally, farmers who receive a PAC will need to reduce the amount of health premiums deductible by the amount of PAC for which they are eligible.[4] This rule prevents the farmer obtaining a deduction and a credit for the same cost of coverage. An adjustment is necessary because the SE health insurance deduction reduces the farmer's income, potentially qualifying the farmer for a larger PAC. A larger PAC, however, will reduce the amount of health premium deductible. This "circular" mathematical relationship between deductible premiums and the PAC amount the farmer may qualify for will require a special mathematical adjustment to arrive at the correct amount of deductible premiums for farmers obtaining a PAC from Marketplace-obtained coverage.

Medical Expenses as an Itemized Deduction

Out of pocket medical costs for the farmer can alternatively be treated as an itemized deduction. The expenses that qualify for itemized deduction include health insurance premiums paid for health insurance. Qualified medical expenses, including health insurance premiums, claimed as an itemized deduction has three disadvantages for the farmer:

- The farmer must itemize (instead of claiming the standard deduction) in order to benefit from this method of claiming health insurance premiums
- The overall amount deductible is limited to the amount in excess of 10% of AGI (or 7.5% of AGI if the farmer or farmer's spouse is age 65 or older before the end of the tax year)[5]

[1] IRC sec. 162(l)(2)(B)
[2] IRC sec. 162(l)(2)(A).
[3] CCA Letter Ruling 200524001 (May 17, 2005).
[4] Rev. Proc. 2014-41, 2014-33 IRB 364; Temp. Treas. Reg. sec. 1.162(l)-1T
[5] IRC sec. 213(f). This lower 7.5% threshold applies through the 2016 tax year.

- Farmers that itemize deductions in higher-income years may face a limit on the amount of overall itemized deductions because of the phaseout rule for itemized deductions

The itemized deduction phaseout income threshold for 2014 is $254,200 for farmers with single filing status, $305,050 for married farmers filing jointly and $152,525 for married farmers filing separately.[1] While the medical expenses claimed are not directly subjected to the itemized phaseout calculation,[2] many other itemized deductions the farmer may claim may be subject to this phaseout, thereby reducing the overall benefit from itemizing.

Given these limitations associated with itemized deductions, the self-employed farmer should claim their health insurance costs under the rules for the self-employed health insurance deduction if possible. Proper planning may provide farmers with the ability to qualify under the rules for that deduction if the farmer does not already qualify. This can mean a substantial increase in the amount of health insurance premiums deductible over the amount deductible as an itemized deduction.

Farmers that qualify for the self-employment health insurance deduction may use that method to claim 100% their health insurance premiums (subject to the business income limitations mentioned) and claim all other qualifying medical expenses as itemized deductions if the farmer chooses to itemize in the year.

Small Farm Businesses Offering Coverage

If the farmer owns a business that provides health coverage to employees, the farm business may qualify for the Small Business Health Care Tax Credit. To qualify for this credit, the farmer's business must:

- Employ less than 25 employees that constitute "full-time equivalents" (special counting rules exist to determine the number of employees under this rule)[3]

- The average annual wages of the full-time equivalent employees (FTEs) is not greater than $50,800 for 2014 ($50,000 for 2010 through 2013)

The farm employer must be required to make a non-elective contribution for each employee enrolled in the health plan in an amount of not less than 50% of the cost of the coverage applied uniformly across employees.

If the farm employer has more than 10 FTEs or pays more than the average annual threshold level of compensation, the farm employer may still qualify for a reduced credit. Note that the special counting rules for FTEs will take into account full-time and part-time employees (so a farm business with over 25 employees may still qualify for the credit once the special counting rules are applied, especially if there are part-time employees).

Generally, in order for the farm employer to qualify for this credit, the insurance and payment arrangement must meet certain guidelines.[4] For 2014 onward, this credit may be claimed by the farm employer for **two consecutive tax years**, even for farm employers that previously qualified for and claimed this credit prior to 2014.

While the maximum credit was 35% of premiums paid by the farm employer in tax years prior to 2014, for 2014 onward the maximum credit has been increased to 50% of premiums paid. Accordingly, this credit can provide a substantial recovery in health insurance costs to a farm employer who offers coverage to employees (including the farmer).

[1] Rev. Proc. 2013-35.
[2] IRC sec. 68(c)(1).
[3] IRC sec. 45R(d)(2)(A).
[4] See IRC sec. 45R(d)(4), (g)(3) and underlying regulations for IRC sec. 45R

Note that for 2014 and subsequent years, however, only health insurance coverage obtained through the Small Business Health Options Program (SHOP) exchange will qualify for this credit.

In addition, if the farm business cannot make use of the credit in a year because there is not tax liability against which the credit may be claimed, the credit is subject to a 20 year carryforward period (providing an added advantage in a later year with taxable income and tax liability). If after 20 years the credit expires without being claimed by the farm business, the farm business may claim it as a deduction in the year following the expiration year.[1] Because the farm business receives a tax credit for premiums paid, the farmer must generally reduce the amount of any health insurance premium deduction it claims by the amount of the credit obtained.

Note. While the Small Business Health Care Tax Credit may provide a significant recovery of premiums paid by the small farm business on behalf of employees in the form of tax savings, the rules are unfortunately quite complex. The small farm business may need to engage in some proactive planning to ensure it qualifies for this credit. More information on this tax credit may be found at www.healthcare.gov/will-i-qualify-for-small-business-health-care-tax-credits/. This website includes a helpful estimator for the farm business to use in determining whether it will qualify and the potential amount of the credit.

Conclusion

Farmers and small farm businesses may be facing increased health insurance costs to comply with the Affordable Care Act. Maximizing the tax savings from the health insurance premiums paid has become increasingly important for farmers and small farm businesses in the wake of the ACA. Some of the tax rules in this area are complex. The farmer should consult with their tax advisor on the best way to reduce health care costs through tax savings and proactive planning may be required for the farmer or small farm business to qualify for the best options.

References

Lovell, M. "Small Farms and the ACA." *farmdoc daily* (4):176, Department of Agricultural and Consumer Economics, University of Illinois at Urbana-Champaign, September 12, 2014.

HealthCare.gov website. “Which Businesses Qualify for SHOP Tax Credits?” Accessed September 24, 2014, https://www.healthcare.gov/will-i-qualify-for-small-business-health-care-tax-credits/

[1] IRC sec. 196(c)(14).