How can I Make Health Expenses Tax Deductible?

DECAL
Thriving Child Care
Business Academy

Health Reimbursement Arrangements (HRA) can benefit your business. Understand how they work and how to get started in this guide.

For child care business owners, staff, and educators, health care can be a major cost and substantial employment benefit. But for many child care businesses, the cost of health care plans can be expensive. Accordingly, some child care businesses are looking at more affordable options for health care that can benefit the owner and employee, but not swamp the business's budget.

One of the most versatile and easy-to-implement options is a Health Reimbursement Arrangement (HRA), formally known as a Section 105 Plan. These plans can work for the single business owner of a family child care home who has an employee to the large child care organization with multiple centers, and everything in between.

In this guide, we will review what an HRA is, how it benefits employers and employees, and how to set one up.

What is an HRA?

An HRA provides a way to reimburse medical expenses for employees and their families. By taking these expenses and making them a business expense, the money associated with them is no longer subject to income or corporate taxes.

These savings can add up (as we will illustrate later in this document).

How does an HRA work?

When you set up a plan, you set a limit to the total amount of health expenses that can be covered in a month or year for each employee and their family members. The limit needs to be the same for all employees (so an owner can't have a greater reimbursement for example).

You can administer your own plan or use a company to do so. Regardless, employees will submit appropriate expenses for review and reimbursement up to their limit. If an employee doesn't hit their limit for the year, the business owner does not have additional financial responsibility. For example, if you have a limit of $1,500 in annual reimbursements and your employee only submits $900, you only pay $900.

Step 1: Employer decides how much to contribute and on what schedule.

Step 2: Employee has medical expense and pays for it.
Step 3: Employee submits receipts for reimbursement.
Step 4: HRA reimburses employee's expense.

We'll go into more detail on how to set up a plan later in this guide.

What kinds of costs will an HRA cover?

These plans cover a wide array of costs including:

- Costs including deductibles and copays for checkups, surgery, and other services
- Health insurance and long-term care premiums
- Dental health and surgery
- Prescriptions
- Vision health and surgery
- Eyeglasses (prescription and reading glasses) and contacts
- Laboratory fees
- Over-the-counter health costs when prescribed by a doctor such as eye drops, acne medicines, sleep aids, allergy medicine, and more
- Orthodontia
- Chiropractic care
- Speech therapy
- Acupuncture
- Psychiatric care
- Medical imaging and X-rays
- Counseling
- OB/GYN fees
- Specialized schools
- Medical devices such as walking aids
- Vaccinations
- Physical therapy
- Infertility treatment

How much can I and my business save?

The savings can add up quickly. On average business owners alone save around $5,000 on taxes. But the savings in self-employment and income taxes can vary based on the business. Here are two examples:

The first example is based on one from leading child care business authority Tom Copeland about a family child care provider (which can also apply to centers):

Without an HRA
There is a family child care provider who is a sole proprietor and is in the 22% income tax bracket.

She had $6,000 in health insurance premium costs and $4,000 in out-of-pocket expenses (including co-pays, prescription drugs, and eyeglasses for two family members). Her spouse is not eligible for health insurance so she can deduct all of her $6,000 in insurance premiums. (If her spouse was eligible for insurance, even if they turned down coverage, these would not be deductible).

Using the personal health insurance deductible for self-employed people, she can deduct only the health insurance premiums off of her income. So, she still pays self-employment tax on the $6,000 of business income that she had to qualify for this deduction but will save on personal income tax.

The out-of-pocket expenses are only deductible when they exceed 7.5% of her adjusted gross income. In most cases, ordinary healthcare costs don't reach this level, so these costs won't be deductible.

Here are her costs and savings for a provider not using an HRA:

Item	Cost (Savings)
Health insurance	$6,000
Out-of-pocket expenses	$4,000
Self-employment tax on health insurance and out-of-pocket expenses ($10,000 x 15.3%)	$1,530
Savings on income tax ($6,000 x 22%)	($1,320)
Total Costs	**$10,210**

As you see, this provider had $10,000 in health expenses and theoretically paid $10,210 for it.

With an HRA

Now let's say she had an HRA. Now she can deduct the full $10,000 as a business expense, eliminating both self-employment and income taxes.

Here's what her costs and savings would be now:

Item	Cost (Savings)
Health insurance	$6,000
Out-of-pocket expenses	$4,000
Savings on self-employment tax ($10,000 x 15.3%)	($1,530)
Savings on income tax ($10,000 x 22%)	($2,200)
Total Costs	**$6,270**

As you see, this same provider had $10,000 in health expenses and paid $6,270 for it. **Through an HRA, the provider saved an additional $3,730!**

Cost comparison of $10,000 in personal health expenses for a sole proprietor

Without an HRA	With an HRA
$10,210	$6,720
(dollars subject to Self-Employment tax)	(dollars not subject to Self-Employment tax)

Now let's explore a second example. This example is for a Center that is a Single Member LLC so it is treated as a sole proprietorship for tax purposes.

> The center owner has four employees and has hired her 16-year-old daughter, so she is eligible for her costs (we'll go into that more later in the document). She sets up an HRA with an annual limit of $1,000 as a way to increase compensation for her staff.

Here's how much of the reimbursement each employee used:

Employee	Amount
Owner's Daughter	$1,000
Employee A	$1,000
Employee B	$800
Employee C	$750
Employee D	$1,000
Total Reimbursements	**$4,550**

Let's now see the impact on taxes for the employer and employee.

For the employer:

Item	Cost (Savings)
Total Reimbursements	$4,550.00
Savings on self-employment taxes ($4,550 x 15.3%)	($696.15)
Savings on income taxes (assuming a rate of 24% x $4,550)	($1,092.00)
Total Costs	**$2,761.85**

The employer only had to pay $2,761.85 in reimbursements, less her tax savings, to offer this $4,550.00 benefit.

And how about her employees? They will save on the employee side of payroll taxes and income tax.

Assuming they are in the 22% tax bracket, their income tax savings would be:

Employee	Amount	Payroll Tax Savings (7.65%)	Maximum Income Tax Savings (22%)	Total Value
Owner's Daughter	$1,000	$76.50	$220	$1,296.50
Employee A	$1,000	$76.50	$220	$1,296.50
Employee B	$800	$61.20	$176	$1,037.20
Employee C	$750	$57.37	$165	$972.37
Employee D	$1,000	$76.50	$220	$1,296.50
			TOTAL	**$5,899.07**

In this example, we can see that not only did the owner benefit, but for $2,761.85 she was able to provide a potential $5,899.07 in value for her employees.

How is this different than a Health Savings Account?

Many employers may also consider a Health Savings Account (HSA). While an HSA can be valuable, an HRA tends to be more versatile and beneficial. One fundamental key difference is that an HSA must be paired with a high-deductible health insurance plan, while an HRA can be used with or without offering a business health insurance plan.

Here is a brief summary of the differences:

HSA	HRA (Section 105 Plan)
Must be paired with a high-deductible plan	Can be offered with or without offing insurance
Contribution limits are set by the government and are capped at $3,650 for single employees and $7,300 for married ones	The upper limit is set by the business owner and can be at any level
Owner needs to contribute to the annual limit even if funds are not used in a given year	Owner only pays for submitted reimbursements up to the annual limit.
Narrow number of eligible expenses focused on medical services	Can include a broad array of physical and mental health services and other costs such as prescriptions and medical devices
Greater recordkeeping requirements	Easier to implement

Does your business qualify?

Businesses with W-2 employees can qualify for an HRA. However, how you implement them and how business owners who are not W-2 employees can benefit depends on the type of business you are.

Here are the different paths for each business type:

- **C Corporation or an LLC treated as a C Corporation:** Since all the company employees (including the owner) are W-2 employees, it can be implemented easily for everyone. You would put a plan in place and start accepting reimbursements.

- **Sole Proprietorships, Partnerships, Single Member LLCs, or Multi-member LLCs treated as Partnerships**: Any W-2 employees will be able to enroll in the HRA, however owners and partners will not. If you can legitimately employ a spouse or child as a W-2 employee you are able to utilize an HRA for that hire. HRA coverage extends to them and their family (including yourself).

  For example, a family child care provider who is a sole proprietor can hire her 16-year-old daughter part-time and create an HRA for the daughter that includes all family members (the daughter, the owner, a spouse, and siblings).

- **S Corporations and an LLC treated as an S Corporation**: All existing W-2 employees and any owners who own less than 2% of the business can participate. Any owners who own more than 2% of the business, even though they are W-2 employees, cannot. Further, relatives of the business owner are considered in this case to be 2% or greater employees so cannot be used for eligibility. However, some business owners will create a separate Sole Proprietorship and employ a relative through that company to gain an eligible W-2 employee. This clearly needs to be justifiable for the business so make sure you do this in coordination with your tax professional.

How do I set up the plan?

You can hire a company to implement the plan for you or have your business implement it directly.

To start, you will want to create a plan document with the "rules" around the plan. You will want to include:

1. Which employees and their relatives should be eligible – for example, you may want to include only full-time employees or those who have been employed with you for a certain number of months or years.
2. The timing of reimbursements – typically this is monthly or quarterly to ensure timely payment and any rules around it, such as having to get payments in within the 30 days of the end of a month or quarter.
3. Eligible expenses and any exclusions – with any limitations or timing, such as having to use your existing insurance first.
4. Employer contribution limits – including the maximum benefit for a set period of time, such as for the month or year. Keep in mind that this should be considered "reasonable compensation" so you don't want to exceed their current pay (so if you hire your spouse for $5,000 a year you should not allow benefits to exceed that level).

These items need to be captured in a plan document. If you use an outside company, they will likely provide this document. If you self-implement, there is an example to consider in Attachment A.

You should also have a simple form for each employee so they can list eligible dependents and acknowledge that they are opting to participate in the plan and that it may end at any time. A form like this should be signed and dated by every employee wanting to participate.

How do I implement an HRA?

With your plan in place, you can now start reimbursing costs. If you have engaged an outside company, they will have an online system or forms for you to use. If you are running your own system, you should have a form (it can be paper or a simple online form) where employees can request reimbursement and provide proof of payment for expenses, such as receipts. These should be reviewed by an independent party – that is, if Employee A normally processes reimbursements, she should not review her own. If it is just you and a relative, you should review all the reimbursements.

Once approved, you can write a check or process the reimbursement through your payroll company and log costs as health-related expenses.

Do I have to report the plan to the government?

Yes, every year, by July 15th you need to file a Form 720 with the federal government to pay a small tax for each participant. Don't worry – the tax is small. For example, in 2022, the maximum fee was $2.79 per average participant.

To complete your Form 720, start with Part I where you will enter your business information at the top.

Form **720** (Rev. September 2022)
Department of the Treasury
Internal Revenue Service

Quarterly Federal Excise Tax Return

▶ See the Instructions for Form 720.
▶ Go to *www.irs.gov/Form720* for instructions and the latest information.

OMB No. 1545-0023

Check here if:
☐ Final return
☐ Address change

Name
Happy Bear Child Care

Quarter ending
June 30, 2022

Number, street, and room or suite no.
(If you have a P.O. box, see the instructions.)
1 Holly Lane

Employer identification number

City or town, state or province, country, and ZIP or foreign postal code
Sugarland, TX XXXXX

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Part I

IRS No.	Environmental Taxes (attach Form 6627, ODCs are ozone-depleting chemicals)			Tax	IRS No.
18	Domestic petroleum oil spill tax				18
21	Imported petroleum products oil spill tax				21
54	Chemicals (other than ODCs)				54
17	Imported chemical substances				17
98	ODCs				98
19	ODC tax on imported products				19
	Communications and Air Transportation Taxes (see instructions)			Tax	
22	Local telephone service and teletypewriter exchange service				22
26	Transportation of persons by air				26
28	Transportation of property by air				28
27	Use of international air travel facilities				27
	Fuel Taxes	Number of gallons	Rate	Tax	
60	(a) Diesel, tax on removal at terminal rack		$.244		
	(b) Diesel, tax on taxable events other than removal at terminal rack		.244		60
	(c) Diesel, tax on sale or removal of biodiesel mixture (not at terminal rack)		.244		
104	Diesel-water fuel emulsion		.198		104
105	Dyed diesel, LUST tax		.001		105
107	Dyed kerosene, LUST tax		.001		107
119	LUST tax, other exempt removals (see instructions)		.001		119
35	(a) Kerosene, tax on removal at terminal rack (see instructions)		.244		
	(b) Kerosene, tax on taxable events other than removal at terminal rack		.244		35

Then move to Part II on page two. You will want to enter the information on IRS number 133, PATIENT-Centered Outcomes Research Fee. Specifically, under Applicable Self-Insured Plans, you will enter the average number of employees covered for the year in the column and then multiply it by the rate in column (b). The line you should use will be determined by when your plan year ends. For example, if you started your plan on November 1, 2022, the plan year end would be 12 months later – October 31, 2023. You then multiply the average number of employees by the rate to get the fee in column (c) and the number for the Tax Column.

1	**Total.** Add all amounts in Part I. Complete Schedule A unless one-time filing ▶	$		

Part II

IRS No.	**Patient-Centered Outcomes Research Fee** (see instructions)	(a) Avg. number of lives covered (see inst.)	(b) Rate for avg. covered life	(c) Fee (see instructions)	Tax	IRS No.
133	Specified health insurance policies					133
	(a) With a policy year ending before October 1, 2021		$2.66			
	(b) With a policy year ending on or after October 1, 2021, and before October 1, 2022		$2.79			
	Applicable self-insured health plans				16.74	
	(c) With a plan year ending before October 1, 2021		$2.66			
	(d) With a plan year ending on or after October 1, 2021, and before October 1, 2022	6	$2.79	16.74		

IRS No.		Rate	Tax	IRS No.
41	Sport fishing equipment (other than fishing rods and fishing poles)	10% of sales price		41
110	Fishing rods and fishing poles (limits apply, see instructions)	10% of sales price		110
42	Electric outboard motors	3% of sales price		42
114	Fishing tackle boxes	3% of sales price		114
44	Bows, quivers, broadheads, and points	11% of sales price		44
106	Arrow shafts	$.55 per shaft		106
140	Indoor tanning services	10% of amount paid		140

IRS No.		Number of gallons	Rate	Tax	IRS No.
64	Inland waterways fuel use tax		$.29		64
125	LUST tax on inland waterways fuel use (see instructions)		.001		125
51	Section 40 fuels (see instructions)				51
117	Biodiesel sold as but not used as fuel				117
20	**Floor Stocks Tax**—Ozone-depleting chemicals (floor stocks). Attach Form 6627.				20
2	**Total.** Add all amounts in Part II ▶			$ 16 74	

Form **720** (Rev. 9-2022)

In Part III you will want to put the total tax from Part II on lines 3 and 10. This will be the amount you will send to the federal government. Also, put in your name, and the date, and make sure you sign before sending.

Form 720 (Rev. 9-2022) Page **3**

Part III

3	Total tax. Add Part I, line 1, and Part II, line 2 ▶	3	16 74
4	Claims (see instructions; complete Schedule C) ▶ 4		
5	Deposits made for the quarter ▶ 5		
	☐ Check here if you used the safe harbor rule to make your deposits.		
6	Overpayment from previous quarters ▶ 6		
7	Enter the amount from Form 720-X included on line 6, if any ▶ 7		
8	Add lines 5 and 6 ▶ 8		
9	Add lines 4 and 8 ▶	9	
10	**Balance Due.** If line 3 is greater than line 9, enter the difference. Pay the full amount with the return (see instructions) ▶	10	16 74
11	**Overpayment.** If line 9 is greater than line 3, enter the difference. Check if you want the overpayment: ☐ **Applied to your next return, or** ☐ **Refunded to you.**	11	

Third Party Designee — Do you want to allow another person to discuss this return with the IRS (see instructions)? ☐ **Yes.** Complete the following. ☐ **No**

Designee name ▶ Phone no. ▶ Personal identification number (PIN) ▶

Sign Here — Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ Signature | Date: July 1, 2022 | ▶ Title: Owner

Type or print name below signature. ▶ Luz Rodriguez | Telephone number ▶ 555-555-5555

Paid Preparer Use Only	Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
	Firm's name ▶			Firm's EIN ▶	
	Firm's address ▶			Phone no.	

Form **720** (Rev. 9-2022)

Finally, you should send a check written to the US Treasury and mail it to:

Department of the Treasury
Internal Revenue Service
Ogden, UT 84201-0009

(Note: you use the same address no matter which state your business is in).

Attachment A: Example Plan Document

Happy Bear Child Care ("Employer") hereby establishes this Section 105 Medical Expense Reimbursement Plan (the "Plan") for the exclusive benefit of its employees.

1. **Medical Expense Reimbursement.** Effective as of XXXXXX, Employer shall reimburse all eligible employees on the basis described in Paragraph Three below for medical expenses described in Paragraph Three that they incur on behalf of themselves, their spouses, and their dependents (as defined in Internal Revenue Code Section 152).
2. **Eligibility.** All employees shall be eligible except employees who work 35 hours or less on average a week.
3. **Qualifying Benefits.** "Medical expenses" shall include any expense qualifying under Internal Revenue Code Section 213(d) up to $75 a month. Employer will only pay expenses that are not covered by insurance policies or benefits of the Employer, employee, or the employee's family.
4. **Reimbursement.** Employer may reimburse the employee for eligible expenses or pay medical providers directly. Employer shall reimburse employee only in the event and to the extent that such expenses are not covered by any insurance policy, policies, or benefits, whether owned by Employer or employee, provided under any other accident or health insurance plan or provided by federal or state governments or agencies. Employees applying for reimbursement shall submit all premium notices and eligible bills not more than 30 days after the end of the month in which they are incurred. Failure to comply with this requirement may terminate employees' right to reimbursement for expenses not submitted in a timely manner.
5. **Unfunded Plan.** This plan shall be unfunded for purposes of the Employee Retirement Income Security Act (ERISA). Plan benefits shall be paid out of Employer's general assets.
6. **Amendment and Termination.** Employer reserves the right to amend or terminate the Plan at any time with 60 days written notice to employees before termination. Such action shall not deny any employee's right to claim reimbursement for expenses incurred before such amendment or termination.
7. **Notice.** Employer shall provide all eligible employees with a copy of this Plan within 90 days of eligibility.

8. **Exclusions.** Employer intends that this Plan and all benefits payable under this Plan shall qualify for exclusion from eligible employees' gross income under Internal Revenue Code Sections 105 and 106. Employer reserves the right to amend or terminate this Plan in the event that such benefits no longer qualify for such exclusion.

The Employer adopts this plan as of the date specified in Paragraph 1.

____
Signature

____
Print Name and Title

Additional Resources

If you have questions or need help, assistance is available.

GaPDS Website

DECAL Thriving Child Care Business Academy Website

Georgia Licensing Rules and Regulations

To Find Other Study Guides: Click on Resources on the Academy home page

To Find Training: Click on Trainings on the Academy home page

To Register for Training: Click on Schedules & Registration on the Academy home page

To Sign Up for Study Groups: Fill out the Intake Assessment

For questions about coaching or study groups: Email GAcoaching@civstrat.com

To Find Other ECE Resources: Visit the DECAL Website

For General Questions about the Academy: Email thriving@decal.ga.gov

For More Information:
Family Child Care Learning Home Rules and Regulations

Child Care Learning Center Rules and Regulations