26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.

(Also Part 1, § 36B).

Rev. Proc. 2014-41

SECTION 1. PURPOSE

This revenue procedure provides guidance that a taxpayer may use to compute the deduction under § 162 of the Internal Revenue Code for health insurance costs for self-employed individuals and the premium tax credit allowed under § 36B.

SECTION 2. BACKGROUND

.01 Under § 162(l), a taxpayer who is an employee within the meaning of § 401(c)(1)—generally, a self-employed individual—is allowed a deduction for all or a portion of the taxpayer's premiums paid during the taxable year for health insurance for the taxpayer, the taxpayer's spouse, the taxpayer's dependents, and any child of the taxpayer under the age of 27. The deduction allowed under § 162(l) is limited to the taxpayer's earned income from the trade or business with respect to which the health insurance plan is established. A taxpayer's § 162(l) deduction is allowed in computing adjusted gross income. See § 62(a)(1).

.02 Section 36B allows a premium tax credit to taxpayers who enroll in a qualified health plan, as defined in § 1.36B-1(c) of the Income Tax Regulations, to assist with the cost of health care coverage. The amount of a taxpayer's premium tax credit is based on the taxpayer's household income as defined in § 36B(d)(2)(A). A taxpayer's household income is calculated using modified adjusted gross income. Modified adjusted gross income is adjusted gross income plus certain items enumerated in § 36B(b)(2)(B). Consequently, the amount of a taxpayer's premium tax credit is based in part on the amount of the taxpayer's adjusted gross income.

.03 Some taxpayers enrolled in a qualified health plan and eligible for the premium tax credit may also be allowed a deduction under § 162(l). Section 1.162(l)-1T of the Temporary Income Tax Regulations provides rules for taxpayers who claim a § 162(l) deduction and also may be eligible for a § 36B credit for the same qualified health plan or plans. Under § 1.162(l)-1T(a)(1), a taxpayer is allowed a § 162(l) deduction for specified premiums not to exceed an amount equal to the lesser of (1) the specified premiums less the premium tax credit attributable to the specified premiums, and (2) the sum of the specified premiums not paid through advance credit payments and the additional tax imposed under § 36B(f)(2)(A) and § 1.36B-4(a)(1) with respect to the specified premiums after the application of the limitation on additional tax in § 36B(f)(2)(B) and § 1.36B-4(a)(3). Specified premiums are premiums for a specified qualified health plan or plans for which the taxpayer may otherwise claim a deduction under § 162(l). A specified qualified health plan is a qualified health plan, as defined in §1.36B-1(c), covering the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer (enrolled family member) for a month that is a coverage month within the meaning of § 1.36B-3(c) for the enrolled family member. *See* § 1.162(l)-1T(a)(2). If a specified qualified health plan covers individuals other than enrolled family members, the specified premiums include only the portion of the premiums for the specified qualified health plan that is allocable to the enrolled family members under rules similar to § 1.36B-3(h), which provides rules for determining the amount under § 1.36B-3(d)(1) when two families are enrolled in the same qualified health plan. *See* § 1.162(l)-1T(a)(2). Specified premiums not paid through advance credit payments equal the amount of the specified premiums minus the advance credit payments attributable to the specified premiums. *See* § 1.162(l)-1T(a)(3).

.04 Taxpayers who receive advance credit payments for a plan for which they claim a § 162(l) deduction determine the limit on additional tax under § 36B(f)(2)(B) using the rules in § 1.36B-4T(a)(3)(iii). These rules require the taxpayer to determine whether the taxpayer can meet the requirements to use a limitation on additional tax by testing the lowest limitation amount and sequentially moving up to the highest limitation amount. To meet the requirements for a limitation amount, the taxpayer's household income as a percentage of the Federal poverty line must be less than or equal to the maximum household income as a percentage of the Federal poverty line for which that limitation is available. For these purposes, household income is determined by using a § 162(l) deduction equal to the sum of specified premiums for the plan not paid through advance credit payments and the limitation amount in addition to any deduction allowable under § 162(l) for premiums other than specified premiums. If the taxpayer cannot meet the requirements for any limitation amount, the limitation on additional tax in § 36B(f)(2)(B) does not apply to the taxpayer.

.05 Because the § 162(l) deduction is allowed in computing adjusted gross income and because adjusted gross income is necessary for computing the premium tax credit, the taxpayer must know the allowable § 162(l) deduction to compute the premium tax credit. Thus, the amount of the § 162(l) deduction is based on the amount of the § 36B premium tax credit, and the amount of the credit is based on the amount of the deduction – a circular relationship. Consequently, a taxpayer eligible for both a § 162(l) deduction for premiums paid for qualified health plans and a § 36B premium tax credit may have difficulty determining the amounts of those items.

SECTION 3. SCOPE

This revenue procedure applies to a taxpayer who is allowed a deduction under § 162(l) for the taxable year for specified premiums, as defined in § 1.162(l)-1T(a)(2). This revenue procedure is intended to provide taxpayers with calculation methods that resolve the circular relationship between the § 162(l) deduction and the § 36B tax credit and that satisfy the requirements of applicable tax law. Using the calculations in this revenue procedure is optional. A taxpayer may determine amounts of the § 162(l) deduction and the § 36B tax credit using any method, provided that the amounts claimed satisfy the requirements of applicable tax law, including § 36B, § 162(l), and the regulations issued under those sections.

SECTION 4. DEDUCTION FOR PREMIUMS OTHER THAN SPECIFIED PREMIUMS

The calculations in section 5 of this revenue procedure apply only to specified premiums, as defined in § 1.162(l)-1T(a)(2). A taxpayer should not apply the calculations or the rules in this revenue procedure to premiums that are not specified premiums. Examples of premiums that are not specified premiums are: premiums paid for coverage other than a qualified health plan; premiums paid for a qualified health plan other than during a coverage month; and premiums paid to cover an individual other than the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer. To the extent a taxpayer may claim a § 162(l) deduction for premiums that are not specified premiums, the taxpayer should treat the deductions as the taxpayer treats all other deductions in determining adjusted gross income, modified adjusted gross income, and household income. *See* Example 3 of section 7 for an example illustrating the application of this section 4.

SECTION 5. COMPUTATIONS

A taxpayer described in section 3 of this revenue procedure may use the calculations described in this section 5 to determine the amounts of the § 162(l) deduction for specified premiums and the premium tax credit. Taxpayers who received advance credit payments should determine which limit on additional tax applies by following the rules in § 1.36B-4T(a)(3)(iii) before performing the computations in this section. Taxpayers may use either the iterative calculation in section 5.01 or the alternative calculation described in section 5.02 to compute the § 162(l) deduction for specified premiums and the premium tax credit. Section 5.03 provides additional detail on applying the limitations in § 162(l) when performing the calculations in sections 5.01 and 5.02.

.01 Iterative calculation

(1) Step 1: Determine adjusted gross income, modified adjusted gross income, and household income by taking a § 162(l) deduction for the amount of specified premiums after applying the limit in section 5.03;

(2) Step 2: Compute the premium tax credit using the adjusted gross income, modified adjusted gross income, and household income determined in Step 1;

(3) Step 3: Determine the § 162(l) deduction by subtracting the Step 2 premium tax credit amount from the specified premiums and then applying the limit in section 5.03;

(4) Step 4: Compute the premium tax credit using the adjusted gross income, modified adjusted gross income and household income determined by taking into account the § 162(l) deduction in Step 3;

(5) Step 5: Repeat Step 3 by substituting the Step 4 premium tax credit for the Step 2 premium tax credit.

(6) Step 6: If changes in both the § 162(l) deduction and the premium tax credit from Steps 2 and 3 to Steps 4 and 5 are less than $1, use the section 162(l) deduction and premium tax credit amounts for the specified premiums determined in Steps 4 and 5. If the change in either the § 162(l) deduction or the premium tax credit from Steps 2 and 3 to Steps 4 and 5 is not less than $1, repeat Steps 4 and 5 (using amounts determined in the immediately preceding iteration) until changes in both the § 162(l) deduction and the premium tax credit between iterations are less than $1.

The taxpayer may claim a premium tax credit and § 162(l) deduction for the specified premiums equal to the amounts determined under Step 6. If a taxpayer is unable to complete Step 6 because changes between iterations always exceed $1, the taxpayer should not use the iterative calculation method, but may use the alternative calculation method in section 5.03 or another method that produces amounts that satisfy applicable tax law.

.02 Alternative calculation

(1) Step 1: Determine adjusted gross income, modified adjusted gross income, and household income by taking a § 162(l) deduction for the amount of specified premiums after applying the limit in section 5.03;

(2) Step 2: Compute the initial premium tax credit using the adjusted gross income, modified adjusted gross income, and household income determined in Step 1;

(3) Step 3: Determine the § 162(l) deduction by subtracting the Step 2 premium tax credit amount from the specified premiums and then applying the limit in section 5.03;

(4) Step 4: Compute the final premium tax credit using the adjusted gross income, modified adjusted gross income and household income determined by taking into account the § 162(l) deduction in Step 3.

The taxpayer may claim the amount of the premium tax credit determined under Step 4 and the amount of § 162(l) deduction for the specified premiums determined under Step 3.

.03 Limits on § 162(l) deduction

(1) This section 5.03 applies to the iterative calculation in section 5.01 and the alternative calculation in section 5.02. *See* Example 1 of section 7 for an example illustrating this section 5.03.

(2) A taxpayer's § 162(l) deduction may not exceed the lesser of:

(A) The taxpayer's earned income (within the meaning of § 401(c)) derived by the taxpayer from the trade or business with respect to which the health insurance is established; and

(B) The sum of (1) the specified premiums not paid through advance credit payments, and (2) the limitation on additional tax determined under § 1.36B-4T(a)(3)(iii).

SECTION 6. TAXPAYERS WITH COVERAGE MONTHS FOR WHICH NO SECTION 162(l) DEDUCTION IS ALLOWED

This section 6 applies to taxpayers described in section 3 of this revenue procedure who have a premium assistance amount, as described in § 36B(b)(2) and § 1.36B-3(d), for one or more coverage months for premiums that are not specified premiums. For example, if a taxpayer has a premium assistance amount for all months of a taxable year but, because the taxpayer began operating a trade or business in September of the year, has specified premiums for just the last four months of the taxable year, this section 6 applies. Taxpayers to whom this section 6 applies should complete Step 3 of the alternative calculation, and Step 3 and the corresponding succeeding Steps in the iterative calculation, except substituting "premium tax credit determined in Step 2 but only with respect to months in which specified premiums were paid" for "premium tax credit determined in Step 2."

See Example 4 of section 7 for an example illustrating the application of this section 6.

SECTION 7. EXAMPLES

Example 1: In 2014, A, A's spouse, and their two dependent children enroll in the second-lowest-cost silver plan, with an annual premium of $14,000. A is engaged in a trade or business as a sole proprietor and has household income (before taking into account the § 162(l) deduction) of $82,425, which includes $75,000 of earned income (within the meaning of § 401(c)) derived by the taxpayer from the trade or business with respect to which the health insurance is established. A received $10,500 in advance credit payments for the year. Because A received advance credit payments, A determines which limitation on additional tax applies under § 1.36B-4T(a)(3)(iii) and determines that A's limitation on additional tax is $2,500. A performs the alternative calculation as follows:

(1) Step 1. A determines the § 162(l) deduction after application of the limit in section 5.03. Under section 5.03, A's § 162(l) deduction is $6,000, the sum of (1) the specified premiums not paid through advance credit payments, $3,500 ($14,000 premiums - $10,500 of advance credit payments); and (2) the limitation on additional tax determined under § 1.36B-4T(a)(3)(iii), $2,500. A's Step 1 household income is $76,425 ($82,425 - $6,000), which is 325 percent of the Federal poverty line for a family of 4 (applicable percentage of 9.5).

(2) Step 2. A's initial premium tax credit based on household income of $76,425 is $6,740 ($76,425 x .095 = $7,260; $14,000 - $7,260 = $6,740).

(3) Step 3. A computes the specified premiums minus the premium tax credit as $7,260 ($14,000 - $6,740). However, as in Step 1, the limit in section 5.03 applies so that A's § 162(l) deduction may not exceed $6,000.

(4) Step 4. A's household income based on a § 162(l) deduction of $6,000 is $76,425. A's premium tax credit based on household income of $76,425 is $6,740 ($76,425 x .095 = $7,260; $14,000 - $7,260 = $6,740).

A's allowable § 162(l) deduction is the amount determined under Step 3, $6,000, and A's premium tax credit is the amount determined under Step 4, $6,740.

If A chose to use the iterative calculation, the result would be the same.

Example 2: In 2014, B, B's spouse, and their two dependent children enroll in the applicable second-lowest-cost silver plan, with an annual premium of $14,000. B is engaged in a trade or business as a sole proprietor and has household income (before taking into account the § 162(l) deduction for specified qualified health plans) of $82,425, which includes $75,000 of earned income (within the meaning of § 401(c)) derived by B from the trade or business with respect to which the health insurance is established. B has no advance credit payments for the taxable year. B uses the alternative calculation in section 5.02 to determine the allowable § 162(l) deduction and premium tax credit as follows:

(1) Step 1. Specified premiums are $14,000 and B has no advance credit payments. B's Step 1 household income is $68,425 ($82,425 - $14,000), which is 291 percent of the Federal poverty line for a family of 4 (applicable percentage of 9.24). B's § 162(l) deduction is not limited under section 5.03 because B has more than $14,000 of earned income from the trade or business and B has no advance credit payments.

(2) Step 2. B's initial premium tax credit based on household income of $68,425 is $7,678 ($68,425 x .0924 = $6,322; $14,000 - $6,322 = $7,678).

(3) Step 3. B's § 162(l) deduction is $6,322 ($14,000-$7,678). B's § 162(l) deduction is not limited under section 5.03 because B has more than $6,322 of earned income from the trade or business and B has no advance credit payments.

(4) Step 4. B's household income is $76,103 ($82,425 - $6,322), which is 323 percent of the Federal poverty line for B's family size (applicable percentage of 9.5). B's premium tax credit based on household income of $76,103 is $6,770 ($76,103 x .095 = $7,230; $14,000 - $7,230 = $6,770).

B's allowable § 162(l) deduction is the amount determined under Step 3, $6,322, and B's premium tax credit is the amount determined under Step 4, $6,770.

If B instead uses the iterative calculation under section 5.01, B would repeat Steps 3 and 4 using premium tax credit and § 162(l) deduction amounts in the immediately preceding iteration until changes in the credit and § 162(l) deduction between iterations are less than $1. In this case, B's allowable § 162(l) deduction would be $7,151 and B's premium tax credit would be $6,849.

<u>Example 3</u>: Same facts as Example 2, except that B also enrolls his non-dependent, 26-year old daughter in individual market coverage not offered on an Exchange. This coverage has an annual premium of $3,000. Under § 162(l)(1)(D), B is allowed a deduction for the premiums for coverage of the non-dependent 26-year old child. However, because the daughter is not a dependent, months of coverage for the daughter are not coverage months, and B may not receive a premium tax credit for B's daughter's coverage. B uses the alternative calculation in section 5.02 to determine the allowable § 162(l) deduction and premium tax credit as follows:

(1) Because none of the months of coverage for B's non-dependent are coverage months, B should apply the rule in section 4 first. Under section 4, B reduces his household income by the § 162(l) deduction he may claim for the non-dependent--$3,000--before performing any calculations in section 5 of this revenue procedure. B also does not include this portion of the § 162(l) deduction in performing either the iterative or the alternative calculation. Thus, before performing Step 1 of the alternative calculation, B begins with household income of $79,425 ($82,425-$3,000) and specified premiums of $14,000 ($17,000 - $3,000).

(2) Step 1. Specified premiums are $14,000 and B has no advance credit payments. B’s Step 1 household income is $65,425 ($79,425 - $14,000), which is 278 percent of the Federal poverty line for a family of 4 (applicable percentage of 8.86). B’s § 162(l) deduction is not limited under section 5.03 because B has $72,000 of earned income not already offset by a § 162(l) deduction ($75,000 - $3,000 already deducted above), which is more than $14,000 and B has no advance credit payments.

(3) Step 2. B’s initial premium tax credit based on household income of $65,425 is $8,203 ($65,425 x .0886 = $5,797; $14,000 - $5,797 = $8,203).

(4) Step 3. B’s § 162(l) deduction is $5,797 ($14,000-$8,203). B’s § 162(l) deduction is not limited under section 5.03 because B has more than $5,797 of earned income from the trade or business and B has no advance credit payments.

(5) Step 4. B’s household income is $73,628 ($79,425 - $5,797), which is 313 percent of the Federal poverty line for B’s family size (applicable percentage of 9.5). B’s premium tax credit based on household income of $73,628 is $7,005 ($73,628 x .095 =

$6,995; $14,000 - $6,995 = $7,005).

B's allowable § 162(l) deduction is $5,797, and B's premium tax credit is $7,005. B's § 162(l) deduction of $5,797 may be claimed in addition to the $3,000 § 162(l) deduction for the daughter's coverage, as described above.

If B chose to use the iterative calculation, B's allowable § 162(l) deduction for specified premiums would be $6,891and B's premium tax credit would be $7,109. B's § 162(l) deduction of $6,891 would be allowable in addition to the $3,000 § 162(l) deduction for the daughter's coverage, as described above.

Example 4: In 2014, C, C's spouse, and their two dependent children enroll in the applicable second-lowest-cost silver plan, with a monthly premium of $1,000. C is engaged in a trade or business as a sole proprietor and has household income (before taking into account the § 162(l) deduction for specified qualified health plans) of $82,425, which includes $18,000 of earned income (within the meaning of § 401(c)) derived by the taxpayer from the trade or business with respect to which the health insurance is established. C has no advance credit payments for the taxable year. C only operates a business from September to December. Because C is a taxpayer described in section 3 and has a premium assistance amount for one or more coverage months for premiums that are not specified premiums, section 6 applies to C. C uses the alternative calculation in section 5.02 to determine the allowable § 162(l) deduction and premium tax credit as follows:

(1) Step 1. Specified premiums are $4,000 (4 x $1,000) and C has no advance credit payments. C's Step 1 household income is $78,425 ($82,425 - $4,000), which is 333 percent of the Federal poverty line for a family of 4 (applicable percentage of 9.5).

C’s § 162(l) deduction is not limited under section 5.03 because C has more than $4,000 of earned income from the trade or business and does not have advance credit payments.

(2) Step 2. C’s initial premium tax credit based on household income of $78,425 is $4,550 ($78,425 x .095 = $7,450; $12,000 - $7,450 = $4,550).

(3) Step 3. Under section 6, C completes Step 3 using “premium tax credit determined in Step 2 but only with respect to months in which specified premiums were paid.” C’s Step 2 premium tax credit with respect to months for which specified premiums were paid is $1,517 ($4,550 x 4/12 = $1,517). Thus, C’s § 162(l) deduction is $2,483 ($4,000 - $1,517). C’s § 162(l) deduction is not limited because C has more than $2,483 of earned income from the trade or business and has no advance credit payments.

(4) Step 4. C’s household income is $79,942 ($82,425 - $2,483), which is 339 percent of the Federal poverty line for C’s family size (applicable percentage of 9.5). C’s premium tax credit based on household income of $79,942 is $4,406 ($79,942 x .095 = $7,594; $12,000 - $7,594 = $4,406).

C’s allowable § 162(l) deduction for specified premiums is the amount determined under Step 3, $2,483, and C’s premium tax credit is the amount determined under Step 4, $4,406.

If C chose to use the iterative calculation, C’s allowable § 162(l) deduction for specified premiums would be $2,530 and C’s premium tax credit would be $4,410.

SECTION 8. EFFECTIVE DATE

This revenue procedure is effective for taxable years beginning after December 31, 2013.

SECTION 9. DRAFTING INFORMATION

The principal author of this revenue procedure is Arvind Ravichandran of the Office of the Associate Chief Counsel (Income Tax and Accounting). For further information regarding this notice, contact Mr. Ravichandran at (202) 622-4920 (not a toll-free call).