

Health Care Reform Alert IRS Guidance on the Small Business Health Care Tax Credit

The Small Business Health Care Tax Credit

The new health care reform law provides a valuable tax credit to some small employers that provide health insurance coverage to their employees. The credit is available beginning this year to employers that pay at least half the cost of their employees' health coverage, have fewer than 25 employees (or an equivalent number of part-time workers) and average wages of less than \$50,000, and meet certain other requirements. An eligible small employer could reduce its health plan expenses by up to 35% by taking advantage of the credit. The Internal Revenue Service (IRS) has recently published important guidance that explains which employers qualify for the credit and how the credit is computed and claimed for tax years beginning in 2010 through 2013.

Overview of the Small Business Health Care Tax Credit

The Affordable Care Act created a new tax credit for certain small employers that sponsor health insurance plans for their employees.¹ For taxable years beginning in 2010 through 2013, qualifying businesses and nonprofit employers with fewer than 25 full-time equivalent (FTE) employees and average wages of \$50,000 or less are entitled to an income tax credit of up to 35 percent (25% for tax-exempt employers) of the employer's premium contributions. For plan years beginning in 2014 or later, the credit amount increases to 50% of employer premiums for taxable employers and 35% for tax-exempts, but will be available to each eligible employer only for two years and only for coverage purchased through one of the health insurance exchanges that are to be established under the health care reform law.

The maximum credit is available to employers with 10 or fewer FTE employees with average annual wages of \$25,000 or less. The credit is completely phased out for employers that have 25 or more FTEs, or that pay average wages of \$50,000 per year or more.

The new tax credit is subject to a number of requirements and limitations, which are explained in more detail in recently issued IRS guidance.² Note that the new IRS guidance is effective immediately and applies for taxable years beginning before January 1, 2014, when the enhanced credit (described above) comes into effect. The remainder of this Alert discusses the credit as in effect for taxable years beginning in 2010-2013, as explained in the Internal Revenue Code and the recent IRS guidance.

¹ The health care tax credit is provided under new section 45R of the Internal Revenue Code.

² The principal guidance is IRS Notice 2010-44, 2010-22 IRB 717 (5/17/2010). The IRS earlier issued Rev. Rul. 2010-13, 2010-21 IRB 691, which provides information on the average premiums for health insurance coverage in the small group market in each state. As explained below, the average small group market premium is relevant to computation of the credit.

Who Is Eligible For The Tax Credit

In order to be eligible to receive the tax credit for a taxable year, an employer must meet each of the following requirements:

1. The employer must be a for-profit employer - a C corporation, limited liability company (LLC), partnership or other taxable entity - or a tax-exempt 501(c) organization.
2. The employer must provide health insurance coverage to its employees under a “qualifying arrangement” (see “Qualifying Arrangements For Employee Health Insurance”, below).
3. The employer must have fewer than 25 full-time equivalent employees for the taxable year (see “Full-Time Equivalent Employees”, below).
4. The employer must have “average annual wages” for FTE employees of less than \$50,000 (see “Average Annual Wages”, below).

“Qualifying Arrangements” For Employee Health Insurance

The new tax credit applies to employer contributions towards health care coverage under “qualifying arrangements”. A “qualifying arrangement” is one which provides health insurance coverage to employees, and under which the employer pays a uniform percentage, not less than 50%, of the total premium cost. “Health insurance coverage” is defined broadly to include (among other things) hospital or medical insurance, whether through an HMO, PPO or traditional indemnity policy, dental, vision and long-term care insurance, specified disease or illness coverage, and Medicare supplemental coverage.³

For purposes of the 50% employer contribution requirement, each type of health insurance coverage offered is tested separately; for example, if the employer offers an HMO health plan and a stand-alone dental plan, each coverage must separately meet the employer contribution requirement. In addition, only non-elective employer premiums are taken into account. Employee contributions under a cafeteria plan are not counted as employer contributions for this purpose.

Full-Time Equivalent Employees

As noted earlier, and disregarding the average annual wage test for the moment, the full credit is available to employers with 10 or fewer FTE employees; the credit begins to be phased out for employers with 11 or more FTE employees and is completely phased out for employers that have 25 or more FTE employees. The number of FTE employees is determined by dividing total hours of service (up to 2,080 per employee) by 2,080, and rounding down to the next lowest whole number.

For this purpose, all members of a “controlled group” of companies are treated as a single employer (thus, a larger employer can’t qualify for the tax credit by dividing into separate entities), and certain owners (including partners, 2% shareholders of S corporations and 5% shareholders of C corporations) and their family members are not counted as employees. In addition, seasonal employees are counted only if they work 120 or more days during the year.

³ For purposes of the tax credit, “health insurance coverage” does *not* include accident or disability insurance, worker’s compensation insurance or coverage for on-site medical clinics, nor does the term include self-insured health plans.

Because the eligibility rules are based (in part) on the number of FTE employees, not the number of employed individuals, businesses that use part-time workers may qualify for the credit even if they employ more than 25 persons.

Example: In calendar year 2010, an employer has 28 employees: 15 who work a full-time schedule of 2,080 hours (40 hours per week), 5 who work 1,560 hours each (30 hours per week) and 8 who work a half-time schedule of 1,040 hours (20 hours per week). The employer has 22 FTE employees, computed as follows:

$$\begin{array}{r} 15 \times 2,080 = 31,200 \\ 5 \times 1,560 = 7,800 \\ 8 \times 1,040 = \underline{8,320} \\ 47,320 \end{array}$$

$$47,320 \div 2,080 = 22.75, \text{ or } \underline{22} \text{ FTE employees when rounded down.}$$

Average Annual Wages

As noted earlier, and disregarding the number of FTE employees for the moment, the full credit is available to employers with average annual wages of \$25,000 or less; the credit begins to be phased out if average wages exceed this amount and is completely phased out for employers that pay average wages of \$50,000 per year or more.

To compute its average annual wages, an employer divides total wages⁴ paid to employees for the hours of service taken into account for the year by the number of FTE employees, and then rounds down to the nearest \$1,000.

How To Compute And Claim the Credit

For plan years beginning before January 1, 2014, the tax credit is computed as follows:

- First, compute the maximum amount of the credit, which is 35% (25% for tax-exempt employers) of the employer's non-elective contributions towards health insurance for its employees under a qualifying arrangement. The employer contributions taken into account are limited to the average premium in the small group market in the employer's state.
 - The IRS has published the average small group market premium rates in effect for 2010 in each of the 50 states. For New York, the applicable rates are \$5,442 per year for employee-only coverage and \$12,867 per year for family coverage.
- Next, reduce the maximum credit amount, if appropriate, pursuant to the phase-out rules. The credit is phased out for eligible employers that have more than 10 FTE employees or average annual wages in excess of \$25,000. If an employer exceeds both thresholds, both reductions apply.

Example: An employer has 10 full-time employees in 2010, and pays 80% of the applicable premium (single or family) for their health insurance. 3 employees have single coverage, for which the annual premium is \$5,000, and the remaining 7 employees have family coverage, for which the premium is \$12,000. The employer's total contribution for health care coverage in 2010 is therefore \$79,200 [80% of (3 x

⁴ The wages used for this purpose are wages subject to FICA tax, disregarding the wage base limit.

\$5,000) + 80% of (7 x \$12,000)]. Assuming the employer meets the other applicable requirements, it would be entitled to a tax credit of \$27,720 [35% of \$79,200].

The Small Business Majority, a trade association, has an online calculator that can be used to estimate the tax credit that an employer could qualify for, taking into account the phase-out rules. It can be accessed here: <http://smallbusinessmajority.org/tax-credit-calculator/> .

Taxable employers can claim the credit on the employer's income tax return as a nonrefundable general business tax credit.

Note: Employer health plan costs are generally deductible, but for years in which the health care tax credit is claimed the otherwise deductible amount must be reduced by the amount of the credit claimed. Employers considering whether to claim the credit must take this into account

For tax-exempt employers, the IRS is still working on how to claim the refundable credit.

If you have any questions about the small employer tax credit or any other aspect of health care reform, please contact Robert W. Patterson at 716.843.3910 or rpatterson@jaeckle.com, or Michele O. Heffernan at 716.843.3850 or mheffernan@jaeckle.com.

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