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IRS explains business credit available to small businesses and tax-exempt organizations under the Health Care Act

This week, the IRS mailed four million postcards to small businesses and tax-exempt organizations alerting them that they may be able to recover a portion of their employee health insurance costs under the newly-enacted Patient Protection and Affordable Care Act (the Health Care Act). (*IR-2010-048*) This mailing followed preliminary IRS guidance explaining the provision of the Health Care Act that provides a tax credit for small businesses and tax exempt organizations that provide health insurance to their employees. (IR-2010-38). In that guidance, the IRS stated that the "credit provides a real boost to eligible small businesses by helping them afford health coverage for their employees." The maximum credit is 35% of the health insurance premiums paid in 2010 by eligible small business employers and 25% of health insurance premiums paid by eligible tax-exempt employers. A governmental employer is not a qualified employer unless it is an organization described in IRC § 501(c) that is exempt from tax under IRC Code §501(a).

Effective in 2014, the maximum credit increases to 50% of health insurance premiums paid by eligible small business employers and 35% of health insurance premiums paid by eligible tax-exempt organizations.

The credit is generally available to employers that have fewer than 25 full-time equivalent (FTE) employees paying wages averaging less than $50,000 per employee per year. The credit phases out gradually for firms with average wages between $25,000 and $50,000 and for firms with the equivalent of between 10 and 25 full-time workers. Because the eligibility formula is based in part

on the number of FTEs, not the number of employees, many businesses will qualify even if they employ more than 25 individual workers. The maximum credit goes to smaller employers — those with 10 or fewer FTEs — paying annual average wages of $25,000 or less.

Example. For the 2010 tax year, a qualified employer has 9 FTEs with average annual wages of $23,000 per FTE. The employer pays $72,000 in health care premiums for those employees (which does not exceed the average premium for the small group market in the employer's State) and otherwise meets the requirements for the credit. The credit for 2010 equals $25,200 (35% x $72,000).

Computing FTEs

The number of an employer's FTEs is determined by dividing the total hours for which the employer pays wages to employees during the year (but not more than 2,080 hours for any employee) by 2,080 hours. The result, if not a whole number, is then rounded to the next lowest whole number.

Example. For the 2010 tax year, an employer pays 5 employees wages for 2,080 hours each, 3 employees wages for 1,040 hours each, and 1 employee wages for 2,300 hours.

The employer's FTEs would be calculated as follows:

(1) Total hours not exceeding 2,080 per employee is the sum of:

a. 10,400 hours for the 5 employees paid for 2,080 hours each (5 x 2,080)
b. 3,120 hours for the 3 employees paid for 1,040 hours each (3 x 1,040)
c. 2,080 hours for the 1 employee paid for 2,300 hours (lesser of 2,300 and 2,080)

These add up to 15,600 hours

(2) FTEs:

7 (15,600 divided by 2,080 = 7.5, rounded to the next lowest whole number)

Computing annual wages

The amount of average annual wages is determined by first dividing the total wages paid by the employer to employees during the employer's tax year by the number of the employer's FTEs for the year. The result is then rounded down to the nearest $1,000 (if not otherwise a multiple of $1,000). For this purpose, wages means wages as defined for FICA purposes (without regard to the wage base limitation).

Example. For the 2010 tax year, an employer pays $224,000 in wages and has 10 FTEs. The employer's average annual wages would be:

$22,000 ($224,000 divided by 10 = $22,400, rounded down to the nearest $1,000)

Reducing the credit when FTEs exceed 10 or average annual wages exceed $25,000

If the number of FTEs exceeds 10 or if average annual wages exceed $25,000, the amount of the credit is reduced as follows (but not below zero). If the number of FTEs exceeds 10, the reduction is determined by multiplying the otherwise applicable credit amount by a fraction, the numerator of which is the number of FTEs in excess of 10 and the denominator of which is 15. If average annual wages exceed $25,000, the reduction is determined by multiplying the otherwise applicable credit amount by a fraction, the numerator of which is the amount by which average annual wages exceed $25,000 and the denominator of which is $25,000. In both cases, the result of the calculation is subtracted from the otherwise applicable credit to determine the credit to which the employer is entitled. For an employer with both more than 10 FTEs and average annual wages exceeding $25,000, the reduction is the sum of the amount of the two reductions. This sum may reduce the credit to zero for some employers with fewer than 25 FTEs and average annual wages of less than $50,000.

Example: For the 2010 tax year, a qualified employer has 12 FTEs and average annual wages of $30,000. The employer pays $96,000 in health care premiums for those employees (which does not exceed the average premium for the small group market in the employer's state) and otherwise meets the requirements for the credit.

The credit is calculated as follows:

(1) Initial amount of credit determined before any reduction: (35% x $96,000) = $33,600
(2) Credit reduction for FTEs in excess of 10: ($33,600 x 2/15) = $4,480
(3) Credit reduction for average annual wages in excess of $25,000: ($33,600 x $5,000/$25,000) = $6,720
(4) Total credit reduction: ($4,480 + $6,720) = $11,200
(5) Total 2010 tax credit: ($33,600 – $11,200) = $22,400.

Covered premiums

Only premiums paid by the employer under a "qualifying arrangement" are counted in calculating the credit. Under a qualifying arrangement, the employer pays premiums for each employee enrolled in health care coverage offered by the employer in an amount equal to a uniform percentage (not less than 50%) of the premium cost of the coverage. However, the IRS and Treasury intend to issue guidance that will provide that, for tax years beginning in 2010, the following transition relief applies with respect to the requirements for a qualifying arrangement:

(a) An employer that pays at least 50% of the premium for each employee enrolled in coverage offered to employees by the employer will not fail to maintain a qualifying arrangement merely because the employer does not pay a uniform percentage of the premium for each such employee. Accordingly, if the employer otherwise satisfies the requirements for the credit described above, it will qualify for the credit even though the percentage of the premium it pays is not uniform for all such employees.

(b) The requirement that the employer pay at least 50% of the premium for an employee applies to the premium for single (employee-only) coverage for the employee. Therefore, if the employee is receiving single coverage, the employer satisfies the 50% requirement with respect to the employee if it pays at least 50% of the premium for that coverage. If the employee is receiving coverage that

is more expensive than single coverage (such as family or self-plus-one coverage), the employer satisfies the 50% requirement with respect to the employee if the employer pays an amount of the premium for such coverage that is no less than 50% of the premium for single coverage for that employee (even if it is less than 50% of the premium for the coverage the employee is actually receiving).

If an employer pays only a portion of the premiums for the coverage provided to employees under the arrangement (with employees paying the rest), the amount of premiums counted in calculating the credit is only the portion paid by the employer. For example, if an employer pays 80% of the premiums for employees' coverage (with employees paying the other 20%), the 80% premium amount paid by the employer counts in calculating the credit. For purposes of the credit (including the 50% requirement), any premium paid on pre-tax basis under a cafeteria plan is not treated as paid by the employer.

In addition, the amount of an employer's premium payments that counts for purposes of the credit is capped by the premium payments the employer would have made under the same arrangement if the average premium for the small group market in the State (or an area within the State) in which the employer offers coverage were substituted for the actual premium. If the employer pays only a portion of the premium for the coverage provided to employees (for example, under the terms of the plan the employer pays 80% of the premiums and the employees pay the other 20%), the premium amount that counts for purposes of the credit is the same portion (80%) of the premiums that would have been paid for the coverage if the average premium for the small group market in the State were substituted for the actual premium. The average premium for the small group market in a State (or an area within the State) will be determined by the Department of Health and Human Services (HHS) and published by the IRS. Publication of the average premium for the small group market on a State-by-State basis was expected to be posted on the IRS website by the end of April.

Maximum credit for tax-exempt qualified employers

For tax years beginning in 2010 through 2013, the maximum credit for a tax-exempt qualified employer is 25% of the employer's premium expenses that count towards the credit. However, the amount of the credit cannot exceed the total amount of income and Medicare (i.e., Hospital Insurance) tax the employer is required to withhold from employees' wages for the year and the employer share of Medicare tax on employees' wages.

Example. For the 2010 tax year, a qualified tax-exempt employer has 10 FTEs with average annual wages of $21,000 per FTE. The employer pays $80,000 in health care premiums for those employees (which does not exceed the average premium for the small group market in the employer's State) and otherwise meets the requirements for the credit. The total amount of the employer's income tax and Medicare tax withholding plus the employer's share of the Medicare tax equals $30,000 in 2010.

The credit is calculated as follows:

(1) Initial amount of credit determined before any reduction: (25% x $80,000) = $20,000
(2) Employer's withholding and Medicare taxes: $30,000
(3) Total 2010 tax credit is $20,000 (the lesser of $20,000 and $30,000).

Qualified employees

In determining if an employee is qualified, the IRS provides specific guidance concerning the following workers and employment arrangements—

(1) Part-time employees. The limitation on the number of employees is based on FTEs; therefore, an employer with 25 or more employees could qualify for the credit if some of its employees work part-time. For example, an employer with 46 half-time employees (meaning they are paid wages for 1,040 hours) has 23 FTEs and therefore may qualify for the credit.

(2) Seasonal employees. Seasonal workers are disregarded in determining FTEs and average annual wages unless the seasonal worker works for the employer on more than 120 days during the tax year.

(3) Sole proprietors, partners and certain shareholders. A sole proprietor, a partner in a partnership, a shareholder owning more than two percent of an S corporation, and any owner of more than five percent of other businesses are not considered employees for purposes of the credit. Thus, the wages or hours of these business owners and partners are not counted in determining either the number of FTEs or the amount of average annual wages, and premiums paid on their behalf are not counted in determining the amount of the credit.

(4) Family members. A family member of any of the business owners or partners listed in above, or a member of such a business owner's or partner's household, is not considered an employee for purposes of the credit. Thus, neither their wages nor their hours are counted in determining the number of FTEs or the amount of average annual wages, and premiums paid on their behalf are not counted in determining the amount of the credit. For this purpose, a family member is defined as a child (or descendant of a child); a sibling or step-sibling; a parent (or ancestor of a parent); a step-parent; a niece or nephew; an aunt or uncle; or a son-in-law, daughter- in-law, father-in-law, mother-in-law, brother-in-law or sister-in-law.

(5*) Members of a controlled group or affiliated service group*. Members of a controlled group (e.g., businesses with the same owners) or an affiliated service group (e.g., related businesses of which one performs services for the other) are treated as a single employer for purposes of the credit. Thus, for example, all employees of the controlled group or affiliated service group, and all wages paid to employees by the controlled group or affiliated service group, are counted in determining whether any member of the controlled group or affiliated service group is a qualified employer. Rules for determining whether an employer is a member of a controlled group or an affiliated service group are provided under Code section 414(b), (c), (m), and (o).

Claiming the credit

The credit is claimed on the employer's annual income tax return; therefore, eligible small businesses can claim the credit as part of the general business credit starting with the 2010 income tax return they file in 2011. For a tax-exempt employer, the IRS will provide further information on how to claim the credit. Except in the case of a tax-exempt employer, the credit for a year offsets only an employer's actual income tax liability (or alternative minimum tax liability) for the year. However, as a general business credit, an unused credit amount can generally be carried back one year and carried forward 20 years. Because an unused credit amount cannot be

carried back to a year before the effective date of the credit, though, an unused credit amount for 2010 can only be carried forward. For a tax-exempt employer, the credit is a refundable credit, so that even if the employer has no taxable income, the employer may receive a refund (so long as it does not exceed the income tax withholding and Medicare tax liability). The credit can be reflected in determining estimated tax payments for the year to which the credit applies in accordance with regular estimated tax rules. In determining the employer's deduction for health insurance premiums, the amount of premiums that can be deducted is reduced by the amount of the credit. The employer may not reduce employment tax payments (i.e., withheld income tax, social security tax, and Medicare tax) during the year in anticipation of the credit. It is also important to note that ***premiums paid by the employer in 2010, but before the Health Care Act was enacted can be counted in calculating the credit.***
