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NATIONAL ASSOCIATION OF INSURANCE AND FINANCIAL ADVISORS

NEW NATIONAL HEALTH INSURANCE LAW

What It Means For You and Your Clients

IRS FAQS ON SMALL BUSINESS HEALTH CARE TAX CREDIT (Revised 4/13/10)

The new health reform law gives a tax credit to certain small employers that provide health care coverage to their employees, effective with tax years beginning in 2010. The following questions and answers issued by the IRS provide information on the credit as it applies for 2010-2013, including information on transition relief for 2010. An enhanced version of the credit will be effective beginning in 2014. The new law, the Patient Protection and Affordable Care Act, was passed by Congress and was signed by President Obama on March 23, 2010.

EMPLOYERS ELIGIBLE FOR THE CREDIT

1. Q: WHICH EMPLOYERS ARE ELIGIBLE FOR THE SMALL EMPLOYER HEALTH CARE TAX CREDIT?

A: Small employers that provide health care coverage to their employees and that meet certain requirements ("qualified employers") generally are eligible for a Federal income tax credit for health insurance premiums they pay for certain employees. In order to be a qualified employer, (1) the employer must have fewer than 25 full-time equivalent employees ("FTEs") for the tax year, (2) the average annual wages of its employees for the year must be less than $50,000 per FTE, and (3) the employer must pay the premiums under a "qualifying arrangement" described in Q/A-3. See Q/A-9 through 15 for further information on calculating FTEs and average annual wages and see Q/A-22 for information on anticipated transition relief for tax years beginning in 2010 with respect to the requirements for a qualifying arrangement.

2. Q: CAN A TAX-EXEMPT ORGANIZATION BE A QUALIFIED EMPLOYER?

A. Yes. The same definition of qualified employer applies to an organization described in Code section 501(c) that is exempt from tax under Code section 501(a). However, special rules apply in calculating the credit for a tax-exempt qualified employer. See Q/A-6.

CALCULATION OF THE CREDIT

3. Q: WHAT EXPENSES ARE COUNTED IN CALCULATING THE CREDIT?

A. Only premiums paid by the employer under an arrangement meeting certain requirements (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 percent) of the premium cost of the coverage. See Q/A-22 for information on transition relief for tax years beginning in 2010 with respect to the requirements for a qualifying arrangement.

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 percent of the premiums for employees' coverage (with employees paying the other 20 percent), the 80 percent premium amount paid by the employer counts in calculating the credit. For purposes of the credit (including the 50-percent requirement), any premium paid pursuant to a salary reduction arrangement under a section 125 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 percent of the premiums and the employees pay the other 20 percent), the premium amount that counts for purposes of the credit is the same portion (80 percent in the example) 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.

4. Q: WHAT IS THE AVERAGE PREMIUM FOR THE SMALL GROUP MARKET IN A STATE (OR AN AREA WITHIN THE STATE)?

A. 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 is expected to be posted on the IRS website by the end of April.

5. Q: WHAT IS THE MAXIMUM CREDIT FOR A QUALIFIED EMPLOYER (OTHER THAN A TAX-EXEMPT EMPLOYER)?

A. For tax years beginning in 2010 through 2013, the maximum credit is 35 percent of the employer's premium expenses that count towards the credit, as described in Q/A-3.

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).

6. Q: WHAT IS THE MAXIMUM CREDIT FOR A TAX-EXEMPT QUALIFIED EMPLOYER?

A. For tax years beginning in 2010 through 2013, the maximum credit for a tax-exempt qualified employer is 25 percent of the employer's premium expenses that count towards the credit, as described in Q/A-3. 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).

7. Q: HOW IS THE CREDIT REDUCED IF THE NUMBER OF FTES EXCEEDS 10 OR AVERAGE ANNUAL WAGES EXCEED $25,000?

A. 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.

8. Q: CAN PREMIUMS PAID BY THE EMPLOYER IN 2010, BUT BEFORE THE NEW HEALTH REFORM LEGISLATION WAS ENACTED, BE COUNTED IN CALCULATING THE CREDIT?

A. Yes. In computing the credit for a tax year beginning in 2010, employers may count all premiums described in Q/A-3 for that tax year.

DETERMINING FTEs AND AVERAGE ANNUAL WAGES

9. Q: HOW IS THE NUMBER OF FTES DETERMINED FOR PURPOSES OF THE CREDIT?

A. The number of an employer's FTEs is determined by dividing (1) 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) 2,080. The result, if not a whole number, is then rounded to the next lowest whole number. See Q/A-12 through 14 for information on which employees are not counted for purposes of determining FTEs.

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. 2080 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)

10. Q: HOW IS THE AMOUNT OF AVERAGE ANNUAL WAGES DETERMINED?

A. The amount of average annual wages is determined by first dividing (1) the total wages paid by the employer to employees during the employer's tax year by (2) 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). See Q/A-12 through 14 for information on which employees are not counted as employees for purposes of determining the amount of average annual wages.

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)

11. Q: CAN AN EMPLOYER WITH 25 OR MORE EMPLOYEES QUALIFY FOR THE CREDIT IF SOME OF ITS EMPLOYEES ARE PART-TIME?

A. Yes. Because the limitation on the number of employees is based on FTEs, 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.

12. Q: ARE SEASONAL WORKERS COUNTED IN DETERMINING THE NUMBER OF FTES AND THE AMOUNT OF AVERAGE ANNUAL WAGES?

A. Generally, no. 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.

13. Q: IF AN OWNER OF A BUSINESS ALSO PROVIDES SERVICES TO IT, DOES THE OWNER COUNT AS AN EMPLOYEE?

A. Generally, no. 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.

14. Q: DO FAMILY MEMBERS OF A BUSINESS OWNER WHO WORK FOR THE BUSINESS COUNT AS EMPLOYEES?

A. Generally, no. A family member of any of the business owners or partners listed in Q/A-13, 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.

15. Q: HOW IS ELIGIBILITY FOR THE CREDIT DETERMINED IF THE EMPLOYER IS A MEMBER OF A CONTROLLED GROUP OR AN AFFILIATED SERVICE GROUP?

A. 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).

HOW TO CLAIM THE CREDIT

16. Q: HOW DOES AN EMPLOYER CLAIM THE CREDIT?

A. The credit is claimed on the employer's annual income tax return. For a tax-exempt employer, the IRS will provide further information on how to claim the credit.

17. Q: CAN AN EMPLOYER (OTHER THAN A TAX-EXEMPT EMPLOYER) CLAIM THE CREDIT IF IT HAS NO TAXABLE INCOME FOR THE YEAR?

A. Generally, no. 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.

18. Q: CAN A TAX-EXEMPT EMPLOYER CLAIM THE CREDIT IF IT HAS NO TAXABLE INCOME FOR THE YEAR?

A. Yes. 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, as discussed in Q/A-6).

19. Q: CAN THE CREDIT BE REFLECTED IN DETERMINING ESTIMATED TAX PAYMENTS FOR A YEAR?

A. Yes. 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.

20. Q: DOES TAKING THE CREDIT AFFECT AN EMPLOYER'S DEDUCTION FOR HEALTH INSURANCE PREMIUMS?

A. Yes. 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.

21. Q: MAY AN EMPLOYER REDUCE EMPLOYMENT TAX PAYMENTS (I.E., WITHHELD INCOME TAX, SOCIAL SECURITY TAX, AND MEDICARE TAX) DURING THE YEAR IN ANTICIPATION OF THE CREDIT?

A. No. The credit applies against income tax, not employment taxes.

ANTICIPATED TRANSITION RELIEF FOR TAX YEARS BEGINNING IN 2010

22. Q: IS IT EXPECTED THAT ANY TRANSITION RELIEF WILL BE PROVIDED FOR TAX YEARS BEGINNING IN 2010 TO MAKE IT EASIER FOR TAXPAYERS TO MEET THE REQUIREMENTS FOR A QUALIFYING ARRANGEMENT?

A. Yes. 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 described in Q/A-3:

(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).