Guidance on the Small Employer Health Care Tax Credit

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This is the sixth in a series of WorkCite articles concerning the recently enacted Patient Protection and Affordable Care Act and its companion bill, the Health Care and Education Reconciliation Act of 2010 (referred to collectively as the act).

The act includes a small employer health care tax credit to help certain employers afford the cost of covering their workers. On May 17, 2010, the Internal Revenue Service (IRS) issued guidance (See Notice 2010-44, hereinafter referred to as the notice) clarifying the rules regarding the small employer health care tax credit. In this installment, we summarize the key elements of the credit, as well as the clarifications that have been made through the notice.

How Much Is the Credit?

- The credit is up to 35 percent of the lesser of:
  - The nonelective premiums paid by the small employer to a qualifying plan; or
  - The amount determined by the U.S. Department of Health and Human Services to be the average premium in the small group health insurance market in the state where the employer is offering coverage.

  Note: For years beginning after 2013, the rate increases to 50 percent, and the premium measurements change.

- Tax-exempt organizations are eligible for a credit of up to 25 percent of the premiums paid (35 percent beginning in 2014).
- The credit phases out gradually for employers whose employees have average wages between $25,000 and $50,000.
- The credit also phases out for employers that have the equivalent of between 10 and 25 full-time equivalent employees (FTEs).

When Does the Credit Become Available?

- The credit is effective for premiums paid on or after Jan. 1, 2010.

How Long Can an Employer Claim the Credit?

- An eligible small employer may claim the credit for 2010 through 2013 and for any two consecutive years after that.

Qualifications for Eligibility

An employer must meet three qualifications in order to be eligible for the credit:

1. It employs fewer than 25 FTEs for the taxable year;
2. The average annual wages of its employees for the year are less than $50,000 per FTE; and
3. It maintains a “qualifying arrangement” under which the employer pays a uniform percentage of at least 50 percent of the premium cost of the health coverage for each employee covered under the employer-provided insurance (a qualifying arrangement).

Note: The controlled group rules of Code section 414(b), (c), (m), and (o) apply to the determination of the size and aggregate wages of the employer. Therefore, all employees of a single controlled group or affiliated service group under the Code, as well as their wages and health plan premiums paid, are taken into account when determining whether the employer meets the above criteria, except to the extent that they are excluded under the next section.

Which Employees Are Taken into Account?

Generally, employees who perform services for the employer during the taxable year are taken into account in determining the employer’s FTEs, average wages and premiums paid. The notice excludes the following groups of people as employees for purposes of the credit:
• Certain owners, such as sole proprietors, partners in a partnership, shareholders owning more than 2 percent of an S corporation, and owners of more than 5 percent of other forms of business;
• Specified family members and dependents of owners and partners; and seasonal workers, unless they work for the employer on more than 120 days during the taxable year (although premiums paid on their behalf may be counted in determining the amount of the credit).

Note: By excluding many owners and working family members, all of whom are often among the most highly compensated employees, many small businesses will find that they meet the qualifying arrangements requirements described above.

Determining the Number of an Employer’s FTEs

The number of an employer’s FTEs is determined by dividing (i) the total hours of service (described below) credited during the year to eligible employees (but not more than 2,080 hours for any employee), by (ii) 2,080 rounded to the next lower whole number.

The notice provides that an employer may use any of the following three methods to calculate the total number of hours of service that must be taken into account for an eligible employee for the taxable year:

1. Determine actual hours of service from records of hours worked and hours for which payment is made or due, including such payment for illness, vacation, holiday and other applicable leave of absence time;
2. Use a days-worked equivalency through which the employee is credited with eight hours of service for each day for which the eligible employee would be required to be credited with at least one hour of service; or
3. Use a weeks-worked equivalency through which the eligible employee is credited with 40 hours of service for each week for which the employee would be required to be credited with at least one hour of service.

Note: These choices are similar to the equivalency rules available for determining hours of service under tax-qualified retirement plans. If some eligible employees work part time, an employer with 25 or more employees may nevertheless qualify for the credit because they will translate into fewer than 25 FTEs.

Determining the Employer’s Average Annual Wages

The average annual wages paid by an employer for a taxable year is determined by dividing (i) the total wages paid by the employer during the taxable year to eligible employees, by (ii) the number of the employer’s FTEs for the year, rounded down to the nearest $1,000.

An eligible employee’s FICA wages (without regard to the wage base limit) are used for this purpose.

Calculating Premium Payments

Only premiums paid by the employer can be used to determine whether a plan is a qualifying arrangement. For this purpose, any premiums paid under a cafeteria plan salary reduction arrangement are not deemed to have been by the employer.

Other Considerations

• **Dental and Vision Coverage Qualifies.** The credit applies to traditional health insurance coverage and also add-on dental, vision, long-term care, home health care, Medicare supplemental plans and other limited-scope coverage.
• **No Reduction Due to State Credits.** If the employer receives a state health care tax credit or subsidy (except in limited circumstances to prevent abuse of the credit), the amount received (i) will not have an effect on whether the plan meets the requirements of a qualifying arrangement, and (ii) will not be used to reduce the credit. Similarly, if the state makes such payments directly to the insurer, the payments will be deemed to have been made by the employer for these purposes. However, the amount of the federal credit may not exceed the employer’s contribution to the plan, net of such state-level health care tax credits and subsidies.
• **Transition Relief for 2010.** The notice formalized transition relief for the 2010 taxable year to provide that an employer will be deemed to satisfy the 50 percent premium requirement to constitute a qualifying arrangement if the employer pays at least 50 percent of the premium for single coverage for each employee receiving single coverage. The same rule also applies where the coverage extends to the employee’s spouse and dependents. Therefore, where the employer’s contribution for employee + 1 or family coverage is at least 50 percent of the premium applicable to a single employee (but is less than 50 percent of the total family premium), it will still qualify for the credit in 2010.

Ongoing Concerns

• The credit is not refundable for taxable small employers. They may use the credit in determining estimated income tax payments for the year to which the credit applies, and, in some instances, they may use it to offset the employer’s alternative minimum tax for that year. They may not use the anticipated credit as an offset against employment tax, but they may carry the unused credit back one year and forward 20 years.
• No deduction is permitted for the portion of the employer-paid premium that is equal to the credit.
• The credit does not resolve the premium payment cash flow issue because it is not taken until the following year.
• Different types of plans are not aggregated for purposes of meeting the qualifying arrangement requirement. Therefore, if an employer sponsors a major medical plan and a stand-alone dental plan, the employer must satisfy the qualifying arrangement requirements separately with respect to each plan in order to have contributions to that plan satisfy the 50 percent test.
• The credit is refundable for tax-exempt small employers to the extent it does not exceed the tax-exempt employer’s income and Medicare tax withholding liability for the year. The IRS will provide more information on how tax-exempt employers may claim the credit.

The timely guidance provided by the notice is extremely helpful in understanding and implementing the small employer health care tax credit. We will continue to issue updates as further guidance or information becomes available.

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