



Tax Credit to Offset Cost of Health Insurance

Calculating the Small Employer Health Insurance Tax Credit for 2010

<p>Type of Clients: Small employers.</p> <p>Situation: The employer pays (or is considering paying) at least 50% of its employees health insurance costs.</p>	<p>Tax Action Required: Read this release to get up to speed on the new small employer health insurance credit. Use the provided tables to quickly estimate the credit amount available to clients.</p>
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Background

For tax years beginning in 2010 through 2013, eligible small employers (including small tax-exempt employers) that purchase health insurance coverage for their employees may be eligible for a tax credit to help offset the cost of the insurance coverage. (See new IRC Sec. 45R.) This is one of the few provisions in the Patient Protection and Affordable Care Act (Health Care Act) that is effective in 2010. It's also one that is likely to be of keen interest to your small employer clients, especially now that the IRS has mailed millions of postcards to small businesses and tax-exempts advising them of its possible availability to save them big tax dollars.

Fortunately, the IRS has been quick to issue guidance on how this credit works, in the form of FAQ's posted on its website, and more recently in Rev. Rul. 2010-13. Here's the scoop on how to calculate a small employer's available credit for 2010.

Note: In 2014 and later, eligible small employers who purchase coverage through a state-run Insurance Exchange will be eligible for a tax credit for two years of up to 50% (35% for tax-exempt employers) of their contribution. Also, the wage limits will be indexed beginning in 2014. As 2014 is a long ways off and the state-run exchanges don't even exist yet, we won't go into those rules any further in this release.

Does the Employer Qualify for the Credit?

Only *eligible small employers* qualify for the credit. An *eligible small employer* is an employer that meets all the following requirements [IRC Sec. 45R(d)]:

1. It employs no more than 25 Full-time Equivalent (FTE) employees during its tax year. FTE employees are determined by dividing the total hours worked by all employees during the year by 2,080 (rounded down to the nearest whole number). However, the maximum hours counted for any one employee is 2,080. Also, the hours worked by seasonal workers aren't counted unless they work for the employer on more than 120 days during the tax year.
2. It pays annual FTE wages that average no more than \$50,000. This is determined by dividing the total wages the employer pays by the number of its FTE employees and then rounding that number down to the nearest \$1,000. For this purpose, wages means wages as defined for FICA purposes (without regard



to the wage base limitation). (See IRS FAQ-10.) Wages paid to seasonal workers are excluded if the worker's hours are excluded in determining the number of FTE employees for item 1.

3. The employer has a qualified health insurance plan (or arrangement) that requires it to pay at least 50% of the premiums (on a uniform basis) on behalf of all of its employees who enroll in the plan.

Observation: An otherwise eligible small employer that is not currently paying any of its employee's health insurance costs that establishes a new arrangement requiring it to pay a uniform percentage of at least 50% of premiums for enrolled employees, will presumably be entitled to the credit for the payments it makes under the plan. It's not entirely clear, however, how an employer that currently has an arrangement that requires it to pay less than 50% of its employee's premiums can correct this situation so that it can qualify for the credit. Hopefully, the IRS will provide guidance on this sometime soon.

Example 1: Fast & Easy (F&E) offers a qualified health insurance plan to its employees. Under the plan, F&E pays 80% of the premiums on behalf of all employees enrolled in the plan.

F&E paid wages totaling \$450,000 to 12 employees who each worked 2,080 hours during 2010, and four employees who each worked 1,560 hours during the year. F&E has 15 FTE employees $\{[(2,080 \times 12) + (1,560 \times 4)] \div 2,080\}$. Its average annual FTE wages are \$30,000 ($\$450,000 \div 15$). Therefore, F&E qualifies for the small employer health insurance tax credit.

Variation: What if F&E is currently paying 40% (instead of 80%) of its enrolled employees' premium, but now wants to increase its pay percentage to 50% so that it can qualify for the credit? It seems logical that F&E should be able to do this as that was the intent of the legislation—to encourage small employers to provide health coverage. But, how is this accomplished? Can (or must) the change be done on a prospective basis only so that only the remaining premiums (the ones it pays 50% of) qualify for the credit, or does F&E have to (or can it) go back and pay 50% of the premiums for the entire year to qualify for the credit?

Self-employed individuals, including partners and sole proprietors, 2% shareholders of an S corporation, 5% owners of the employer [within the meaning of IRC Sec. 416(i)(1)(B)(i)], and dependents of these self-employed individuals are not treated as employees [IRC Sec. 45R(e)(1)]. Thus, no credit is available for any contribution to the purchase of health insurance for these individuals, nor is the individual taken into account in determining the number of FTE employees or average FTE wages.

Members of a controlled group or an affiliated service group as described in IRC Sec. 414(b), (c), (m), and (o) are treated as a single employer for purposes of the credit. Thus, all employees of the group and all wages paid to employees by the group are counted in determining whether any member of the group is an eligible small employer. [See IRC Sec. 45R(e)(5).]

2010 Transitional Rule. Generally, to qualify for the credit, the employer must pay the same percentage (which has to be at least 50%) of all its employees' health insurance premiums. However, according to the IRS FAQ-22, the IRS intends to issue guidance that will provide a transition rule for 2010 only. Under this transition rule, an employer can qualify for the credit even if it pays differing percentages of different employees' premiums as long as all the payments it makes are at least 50% of each employee's premium (based on single—employee only—coverage). For example, an employer satisfies the 50% requirement with respect to the employee with family coverage if the employer pays at least 50% of the premium for single coverage for that employee even though it is less than 50% of the premium for family coverage.

Calculating the Amount of the Credit

Step One—Calculate the Maximum Credit Amount. For tax years beginning in 2010 through 2013, an eligible small employer's maximum credit equals 35% (25% for tax-exempt employers) of the lesser of the following amounts [IRC Sec. 45R(g)(2)]:

1. The amount of contributions the employer made during the tax year to its qualified health arrangement to purchase qualifying health insurance coverage for its employees. Qualifying health insurance coverage is basically health insurance purchased from an insurance company licensed under state law. Only nonelective employer contributions qualify. Basically, this means that employee elective contributions to the plan that are used by the employer to pay for the employee's coverage don't qualify for the credit. Premiums paid in 2010 before the Health Care Act was enacted can qualify for the credit. (See IRS FAQ-8.)
2. The amount of contributions that the employer would have made during the tax year to its qualified health arrangement if each employee had enrolled in coverage with a small business benchmark premium. The small business benchmark premium will be determined by the Secretary of Health and Human Services (HHS) each year on a state-by-state basis. The 2010 table can be found in Rev. Rul. 2010-13 and has been reproduced in Appendix 2 of this release.

Note: The HHS may issue additional 2010 small business benchmark premium rates for certain high cost areas within a state. However, any additional rates provided will not be less than those listed in Appendix 2. Also, if the employer pays only a portion of the employee's premium, the amount in Appendix 2 must be multiplied by the portion paid by the employer. For example, if the employer pays 80% of the employee's premium, the employer's contribution for purposes of item 2 will be 80% of the benchmark premium listed in Appendix 2. (See IRS FAQ-3.)

Step Two—Calculate the Available Credit. The maximum credit is available only to an employer with 10 or fewer FTE employees and whose employees have an average annual FTE wages of less than \$25,000. If the number of FTEs exceeds 10 or if average annual wages exceed \$25,000, the credit available to the employer equals the maximum credit amount calculated in step one reduced by the sum of the following two amounts, as applicable (but not below zero):

1. If the number of FTEs exceeds 10:

$$\text{Maximum Credit} \times \frac{\text{FTEs} - 10}{15}$$

2. If average annual wages exceed \$25,000:

$$\text{Maximum Credit} \times \frac{\text{Average Annual Wages} - \$25,000}{\$25,000}$$

Example 2: Using the same facts as in Example 1 (15 FTEs and \$30,000 average annual wages), assume that for 2010 F&E pays \$96,000 in nonelective health care premiums for its employees, which does not exceed 80% (the percentage of premiums paid by F&E) of the small business benchmark premium for F&E's state and otherwise meets the requirements for the credit.

F&E's credit is \$15,680, calculated as follows:

Maximum credit: (35% × \$96,000)	\$ 33,600
Reduction for FTEs in excess of 10: (\$33,600 × 5 ÷ 15)	(11,200)
Reduction for average annual wages in excess of \$25,000: (\$33,600 × \$5,000 ÷ \$25,000)	<u>\$ (6,720)</u>
Available credit:	<u>\$ 15,680</u>

Short-cut Credit Calculation: To help make your life a little easier, the Appendix 1 provides a table estimating the applicable reduced credit percentage available to employers with varying levels of FTEs and average annual wages. This table can be used to quickly estimate the credit available to a small employer.

Example 3: Using the facts in Example 2, the credit could be quickly estimated to be \$15,360 (16% × \$96,000). This isn't 100% accurate, but it should work for a quick and dirty estimate.

Additional Limit for Tax-exempt Employers. The credit available to tax-exempt employers cannot exceed the total amount of Federal Income Tax (FIT) and Medicare (i.e., hospital insurance) tax the employer is required to withhold from employees' wages for the year, plus the employer's share of Medicare tax on employees' wages.

Claiming the Credit

For-profit Businesses. The small employer health insurance credit will be claimed on the employer's annual income tax return. The credit is a specified general business credit. [See IRC Sec. 38(b)(36) and (c)(4)(B)(vi).] As such, it is available against AMT. Also, any unused credit can be carried back for one year (but not before 2010) and carried forward for 20 years.

Practice Tip: The employer (individual in the case of a sole proprietor) should reduce its estimated tax payments for the year to account for the availability of the credit.

The employer's income tax deduction for premiums it pays on behalf of its employees is reduced by the small employer health insurance credit. [See IRC Sec. 280C(h).]

Tax-exempt Employers. For tax-exempt organizations, instead of being a general business credit, the credit is a refundable tax credit limited to the payroll taxes (defined earlier) paid or withheld during the calendar year in which the employer's tax year begins.

Observation: As the credit offsets their payroll taxes, it would seem logical that tax-exempt employers would claim the credit on their payroll tax returns. However, the IRS has informally indicated that Form 941 (Employers Quarterly Federal Tax Return) will not be amended, but instead small tax-exempt employers will have to claim the credit on Form 990 (Return of Organization Exempt from Income)—presumably they really meant 990-T (Exempt Organization Business Income Tax Return) as Form 990 is not a tax return. In any case, this makes no sense to us—whichever way they go, they'll have to amend a form (whether it be Form 941, 990, or 990-T) or at least provide some sort of guidance. Wouldn't that be a whole lot easier to do on Form 941 where the payroll taxes are reported and paid? Whatever! We'll keep you posted as guidance comes out.

Conclusion

The small employer health insurance tax credit should be a welcome relief for small employers struggling to provide their employees with health insurance coverage. Those already paying for at least 50% of the premiums, will want to know what their tax savings will be. Those not already providing employee health insurance coverage and those providing it, but paying less than 50% of the premiums (or an nonuniform percentage of its employees' premiums), may want to reconsider this decision based on these new tax savings. In any case, you're now armed with information so that you can answer your clients' questions when they call.

References:

IRC Secs. 38(b), 45R, and 280C(h).
Rev. Rul. 2010-13, 2010-21 IRB.

Subscriber Note: This *Tax Action Memo* was written by Senior Manager, Robin Tuttle Christian, CPA. Ms. Christian is Managing Editor of this publication as well as a coauthor and contributing editor of several PPC publications.

Appendix 1

Short-cut Small Employer Insurance Credit Percentage¹

For-profit Business:

Number of employees	Average Wages					
	Up to \$25,000	\$30,000	\$35,000	\$40,000	\$45,000	\$50,000
Up to 10	35%	28%	21%	14%	7%	0%
11	33%	26%	19%	12%	5%	
12	30%	23%	16%	9%	2%	
13	28%	21%	14%	7%		
14	26%	19%	12%	5%		
15	23%	16%	9%	2%		
16	21%	14%	7%			
17	19%	12%	5%			
18	16%	9%	2%			
19	14%	7%				
20	12%	5%				
21	9%	2%				
22	7%					
23	5%					
24	2%					
25	0%					

Nonprofit Entity:

Number of employees	Average Wages					
	Up to \$25,000	\$30,000	\$35,000	\$40,000	\$45,000	\$50,000
Up to 10	25%	20%	15%	10%	5%	0%
11	23%	18%	13%	8%	3%	
12	22%	17%	12%	7%	2%	
13	20%	15%	10%	5%		
14	18%	13%	8%	3%		
15	17%	12%	7%	2%		
16	15%	10%	5%			
17	13%	8%	3%			
18	12%	7%	2%			
19	10%	5%				
20	8%	3%				
21	7%	2%				
22	5%					
23	3%					
24	2%					
25	0%					

Note:

- ¹ These tables are from the Congressional Research Service report *Summary of Small Business Health Insurance Tax Credit Under PPACA*, dated 4/5/2010.

Appendix 2

2010 Small Employer Benchmark Premiums

State	Employee Only Coverage	Family Coverage
Arkansas	4,329	9,677
Arizona	4,495	10,239
California	4,628	10,957
Colorado	4,972	11,437
Connecticut	5,419	13,484
District of Columbia	5,355	12,823
Delaware	5,602	12,513
Florida	5,161	12,453
Georgia	4,612	10,598
Hawaii	4,228	10,508
Iowa	4,652	10,503
Idaho	4,215	9,365
Illinois	5,198	12,309
Indiana	4,775	11,222
Kansas	4,603	11,462
Kentucky	4,287	10,434
Louisiana	4,829	11,074
Massachusetts	5,700	14,138
Maryland	4,837	11,939
Maine	5,215	11,887
Michigan	5,098	12,364
Minnesota	4,704	11,938
Missouri	4,663	10,681
Mississippi	4,533	10,501
Montana	4,772	10,212
North Carolina	4,920	11,583
North Dakota	4,469	10,506
Nebraska	4,715	11,169
New Hampshire	5,519	13,624
New Jersey	5,607	13,521
New Mexico	4,754	11,404
Nevada	4,553	10,297
New York	5,442	12,867
Ohio	4,667	11,293
Oklahoma	4,838	11,002
Oregon	4,681	10,890
Pennsylvania	5,039	12,471
Rhode Island	5,887	13,786
South Carolina	4,899	11,780
South Dakota	4,497	11,483
Tennessee	4,611	10,369
Texas	5,140	11,972
Utah	4,238	10,935
Virginia	4,890	11,338
Vermont	5,244	11,748
Washington	4,543	10,725
Wisconsin	5,222	12,819
West Virginia	4,986	11,611
Wyoming	5,266	12,163

Source: Rev. Rul. 2010-13.