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Small Employers Eligible for Health Care Tax Credit

The Affordable Care Act (ACA) created a **health care tax credit** for certain small employers that provide health insurance coverage to their employees. The tax credit is:

- Designed to encourage small employers to offer health insurance coverage to their employees.
- In general, available to taxable and tax-exempt small employers that pay at least half the cost of single coverage for their employees.
- Effective for tax years beginning after Dec. 31, 2009 (an enhanced version of the credit will be effective beginning in 2014).

The Internal Revenue Service (IRS) issued Notice 2010-44 and Notice 2010-82 to provide guidance on determining eligibility for, calculating and claiming the tax credit for 2010 through 2013 tax years. The IRS is expected to issue guidance on claiming the health care tax credit for tax years after 2013.

This Legislative Brief provides a brief overview of the health care tax credit and explains the steps for determining eligibility for the tax credit.

OVERVIEW OF HEALTH CARE TAX CREDIT

The health care tax credit is intended to help small businesses and tax-exempt organizations that primarily employ low and moderate income workers provide health insurance coverage to their employees. In general, the maximum credit is **35 percent** of premiums paid for taxable small employers and **25 percent** of premiums paid for tax-exempt small employers.

For 2014 tax years and later, the maximum health care tax credit will increase to 50 percent of premiums paid for taxable employers and 35 percent of premiums paid for tax-exempt organizations. The tax credit will only be available to an employer for two consecutive tax years after 2013 and only when coverage is purchased through an ACA insurance exchange.

The maximum credit goes to smaller employers — those with 10 or fewer full time equivalent employees (FTEs) — that pay annual average wages of $25,000 or less. The credit is reduced if the number of FTEs exceeds 10 or if average annual wages exceed $25,000.

If an employer pays only a portion of the premiums for the coverage (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 employee health insurance coverage (with employees paying the other 20 percent), the 80 percent paid by the employer is taken into account when calculating the credit.

The amount of an employer's premium payments that counts for purposes of the credit is capped by the premium payment the employer would have made under the same arrangement if the average premium for the small group market in the employer's geographic location were substituted for the actual premium. The cap that is used for each employee depends on the coverage the employee takes.

Example: For the 2012 tax year, a qualified employer has nine 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 2012 equals $25,200 (35 percent x $72,000).

Both small businesses and tax-exempt organizations use **IRS Form 8941** to calculate the credit. Taxable employers claim the credit on their annual income tax return to offset their tax liability for the year. Tax-exempt organizations must file an **IRS Form 990-T** to claim the health care tax credit. For tax-exempt employers, the credit is refundable, so that an employer without taxable income may receive a refund (as long as it does not exceed the employer's total income tax withholding and Medicare tax liability for the year).

Also, claiming the credit will affect an employer's deduction for health insurance premiums. The amount of premiums that can be deducted is reduced by the amount of the credit.

DETERMINING ELIGIBLITY FOR HEALTH CARE TAX CREDIT

For tax years 2010 through 2013, in order to be eligible for the health care tax credit, an employer must:

- Have no more than **25 full-time equivalent employees** (FTEs);
- Pay **average annual wages of $50,000 or less** per FTE; and
- Maintain a **"qualifying arrangement."** In general, a qualifying arrangement is one where the employer pays premiums for each employee enrolled in its health insurance coverage in an amount equal to a uniform percentage of not less than 50 percent of the premium cost of the coverage.

In most cases, employers that are agencies or instrumentalities of the federal government, or of a state, local or Indian tribal government, are not eligible for the credit.

A section 521 farmers cooperative that is subject to tax under Internal Revenue Code section 1381 is eligible to claim the small business tax credit as a taxable employer, if it otherwise meets the definition of an eligible small employer.

For tax years that begin before Jan. 1, 2014, an employer that otherwise meets the requirements for the tax credit may claim the credit even if its employees are not performing services in a trade or business. For example, a household employer may be eligible for the health care tax credit.

In addition, for tax years 2010 through 2013, an eligible small employer (including a tax-exempt eligible small employer) that is located outside the United States may claim the tax credit only if it pays premiums for an employee's health insurance coverage that is issued in and regulated by one of the 50 states or the District of Columbia.

Step One – Determine the Employees Who Are Taken Into Account

In general, employees who perform services for the employer during the taxable year are taken into account when determining if the employer is eligible for the health care tax credit. This includes former employees who terminated employment during the year, employees covered under a collective bargaining agreement and employees who did not enroll in the employer's health insurance plan.

In addition, all employees of a controlled group or an affiliated service group, including their wages and premiums, are taken into account when determining if an employer is eligible for the health care tax credit.

Leased employees are counted in determining an employer's eligibility for the tax credit. However, the premiums for health insurance coverage paid by a leasing organization for leased employees are not taken into account in calculating the amount of the credit.

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In addition, a minister performing services in the exercise of his or her ministry is taken into account if he or she is an employee under the common law test for determining worker status (employee vs. self-employed). However a minister's compensation is not considered wages for purposes of computing the employer's average annual wages.

The following individuals are **not** included in this determination:

- Seasonal workers are disregarded in determining FTEs and average annual wages, unless a seasonal worker worked for the employer on more than 120 days during the taxable year. However, premiums paid on their behalf may be counted in determining the amount of the health care tax credit.
- Business owners, including 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 taken into account for purposes of the credit.
- Members of a business owner's family or household (including spouses) are also disregarded for purposes of the health care tax credit.

Step Two – Determine the Hours of Service Performed by These Employees

An employee's hours of service for a year include each hour for which an employee is paid, or entitled to payment, for the performance of duties for the employer during the employer's taxable year.

It also includes each hour for which an employee is paid, or entitled to payment, by the employer on account of a period of time when no duties are performed due to vacation, holiday, illness, incapacity (including disability), layoff, jury duty, military duty or leave of absence. No more than 160 hours of service are required to be counted for an employee during any single continuous period during which the employee does not perform any duties.

An employer may use any of the following methods to calculate employees' hours of service for the taxable year:

- Counting **actual hours** worked;
- Using a **days-worked equivalency method** where the employee is credited with eight hours of service for each day for which the employee would be required to be credited with at least one hour of service because he or she is paid or entitled to payment; or
- Using a **weeks-worked equivalency method** where the 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 because he or she is paid or entitled to payment.

An employer does not need to use the same method for all employees; different methods may be used for different classifications of employees, if the classifications are reasonable and consistently applied. For example, an employer may use the actual hours worked method for all hourly employees and the weeks-worked equivalency method for all salaried employees. In addition, employers may change the method for calculating employees' hours of service for each taxable year.

Example: For the 2012 taxable year, an employer's payroll records indicate that Employee A worked 2,000 hours and was paid for an additional 80 hours on account of vacation, holiday and illness. The employer counts **hours actually worked**. Under this method of counting hours, Employee A must be credited with 2,080 hours of service (2,000 hours worked and 80 hours for which payment was made or due).

Example: For the 2012 taxable year, Employee B worked 49 weeks, took two weeks of vacation with pay, and took one week of leave without pay. The employer uses the **weeks-worked equivalency method**. Under this method of counting hours, Employee B must be credited with 2,040 hours of service (51 weeks multiplied by 40 hours per week).

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Step Three – Calculate the Number of FTEs

The number of an employer's FTEs is determined by dividing (1) the total hours of service credited during the year to employees (but not more than 2,080 hours for any employee) by (2) 2,080.

The result, if not a whole number, is rounded down to the next lowest whole number. If, after dividing the total hours of service by 2,080, the resulting number is less than one, the employer rounds up to one FTE.

Because the tax credit's eligibility formula is based in part on the number of FTEs, not the number of employees, some businesses will qualify even if they employ more than 25 individual workers. For example, an employer with 46 half-time employees (that is, employees paid for 1,040 hours) has 23 FTEs and may qualify for the tax credit.

Example: For the 2012 taxable year, an employer pays five employees wages for 2,080 hours each, three employees wages for 1,040 hours each and one employee wages for 2,300 hours. The employer does not use an equivalency method to determine hours of service for any of these employees. The employer's FTEs would be calculated as follows:

- Total hours of service not exceeding 2,080 per employee is the sum of:
    - 10,400 hours of service for the five employees paid for 2,080 hours each (5 x 2,080);
    - 3,120 hours of service for the three employees paid for 1,040 hours each (3 x 1,040); and
    - 2,080 hours of service for the one employee paid for 2,300 hours (lesser of 2,300 and 2,080).
- The sum of the above equals 15,600 hours of service.
- FTEs equal 7 (15,600 divided by 2,080 = 7.5, rounded to the next lowest whole number).

Step Four – Calculating Average Annual Wages

An employer's average annual wages is determined by dividing (1) the total wages paid by the employer to employees 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).

Only wages that are paid for hours of service are taken into account. Wages for this purpose means FICA wages, including overtime pay, determined without regard to the wage base limitation. Thus, for example, if an employee works more than 2,080 hours in a year, all wages paid to the employee, including wages for the hours in excess of 2,080, are taken into account in computing the employer's average annual wages.

Example: For the 2012 taxable year, an employer pays $224,000 in wages and has 10 FTEs. The employer's average annual wages is $22,000 ($224,000 divided by 10 = $22,400, rounded down to the nearest $1,000).

Step Five – Determining Whether Coverage Is a Qualifying Arrangement

A qualifying arrangement is one where the employer pays premiums for each employee enrolled in **health insurance 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.

Health Insurance Coverage

Health insurance coverage for purposes of a qualifying arrangement must be offered by a health insurance issuer. Therefore, a self-insured plan is not considered to be health insurance coverage for the credit and employer contributions to self-insured plans are not qualifying arrangements. Because account-based plans are not health insurance coverage, employer contributions to HRAs, health FSAs and HSAs are also not qualifying arrangements.

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In addition, for years prior to 2014, health insurance coverage for purposes of the credit means benefits consisting of medical care (provided directly, through insurance or reimbursement, or otherwise) under any hospital or medical service policy or certificate, hospital or medical service plan contract, or health maintenance organization contract offered by a health insurance issuer. It also includes:

- Limited scope dental or vision plans;
- Plans providing long-term care, nursing home care, home health care, community-based care or any combination of these types of care;
- Coverage only for a specified disease or illness;
- Hospital indemnity or other fixed indemnity insurance; and
- Medicare supplemental health insurance, certain other supplemental coverage and similar supplemental coverage provided to coverage under a group health plan.

However, health insurance coverage does **not** include certain excepted benefits, such as:

- Coverage only for accident, or disability income insurance, or a combination of the two;
- Coverage issued as a supplement to liability insurance;
- Liability insurance, including general liability insurance and automobile liability insurance;
- Workers' compensation or similar insurance;
- Automobile medical payment insurance;
- Credit-only insurance;
- Coverage for on-site medical clinics; or
- Other similar insurance coverage, specified in regulations, under which benefits for medical care are secondary or incidental to other insurance benefits.

Different types of health insurance plans are not aggregated for purposes of meeting the qualifying arrangement. For example, if an employer offers a major medical insurance plan and a stand-alone vision plan, the employer must separately satisfy the requirements for a qualifying arrangement with respect to each type of coverage.

Contributions by an employer to a multiemployer plan that are used to pay premiums for health insurance coverage for employees are treated as payment of health insurance premiums by the employer. However, self-insured health coverage provided through a multiemployer plan is not health insurance coverage provided under a qualifying arrangement. Also, employer contributions for benefits other than health insurance are not taken into account.

Because a church welfare benefit plan is subject to state insurance law enforcement, it satisfies the requirements for health insurance coverage. Therefore, for purposes of the tax credit, an arrangement under which a small church employer pays premiums for employees who receive medical care provided though a church welfare benefit plan may be a qualifying arrangement.

Uniform Percentage Requirements

As explained above, to be eligible for the credit, an employer must pay a uniform percentage (at least 50 percent) of the premium for each employee enrolled in the employer's health insurance coverage. This rule is known as the "uniformity requirement."

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Applying the uniformity requirement will depend on **whether the employer offers more than one plan** (each benefits package is considered a separate plan) and on **whether the employer's insurer uses composite or list billing**.

- Composite billing means that a health insurer charges a uniform premium for each of the employer's employees or charges a single aggregate premium for the group of covered employees that the employer may divide by the number of covered employees to determine the uniform premium.
- List billing means that a health insurer charges a separate premium for each employee based on employee's age or other factors.

Employers with One Plan

Employers that offer one plan and use composite billing must pay the same amount toward the premium for each employee receiving coverage that is at least 50 percent of the cost for employees enrolled in self-only coverage. For additional tiers of coverage, employers can follow that rule or pay an amount for each employee enrolled in a more expensive tier of coverage that is the same for all employees and is no less than the amount that the employer would have contributed toward self-only coverage.

If an employer with one plan uses list billing, it must follow similar rules, although it can convert the individual premiums for self-only coverage into an employer-computed composite rate for self-only coverage.

Employers with More Than One Plan

Employers with more than one plan may satisfy the uniformity requirement by applying one of the rules set forth above on a plan-by-plan basis. Note that the amounts or percentage of premium paid by the employer for each plan do not need to be identical.

Alternatively, the employer may designate one "reference plan" and make employer contributions in accordance with the rules in Notice 2010-82. The employer must determine a level of contributions for each employee such that, if all eligible employees enrolled in the reference plan, the contribution rules for a single plan would be satisfied. The employer must also permit each employee to apply the contribution amount to either the reference plan or toward the cost of coverage under any of the other available plans.

If the employer chooses to use a reference plan, the self-only composite rate for the reference plan must be must at least 66 percent of the self-only composite rate for each not-reference plan for which the employer is claiming the credit.

Transition Relief

The IRS provided transition relief in applying the uniformity requirement for tax years beginning in 2010. For tax years beginning in 2010, employers could choose between the requirements described above or the IRS's transition relief. Under the transition rules, an employer is considered to satisfy the uniformity requirement if it pays an amount equal to at least 50 percent of the premium for single (employee-only) coverage for each employee enrolled in the employer's health insurance coverage, even if the employer does not pay the same percentage of the premium for each employee.

Example: For the 2010 tax year, an eligible small employer has nine FTEs with average annual wages of $23,000 per FTE. Six employees are enrolled in single coverage and three employees are enrolled in family coverage. The premiums are $8,000 for single coverage for the year and $14,000 for family coverage for the year. The employer pays 50 percent of the premium amount for single coverage ($4,000) for each employee (whether enrolled in single or family coverage). Thus, the employer pays $4,000 of the premium for each of the six employees enrolled in single coverage and $4,000 of the premium for each of the three employees enrolled in family coverage. The employer is deemed to satisfy the uniformity requirement for a qualifying arrangement under the transition relief rule.

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MORE INFORMATION

For more information on the health care tax credit, including calculating and claiming the credit, please contact your Gowrie Group representative. Also, more information about the tax credit, including tax tips, guides and answers to frequently asked questions, is available from the IRS at: www.irs.gov/newsroom/article/0,,id=223666,00.html.

For a tax credit calculator, please see www.smallbusinessmajority.org/tax-credit-calculator/ or www.nfib.com/issues-elections/healthcare/credit-calculator.

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