



Legislative Brief

Small Businesses Eligible for Health Care Tax Credit

EXECUTIVE SUMMARY

Under the health care reform law enacted in 2010, many small businesses and tax-exempt organizations that provide health insurance coverage to their employees now qualify for a special tax credit. The credit is:

- designed to encourage small employers to offer health insurance coverage for the first time or maintain coverage they already have
- in general, available to small employers that pay at least half the cost of single coverage for their employees
- available for tax years beginning in 2010 (an enhanced version of the credit will be effective beginning in 2014)

The Internal Revenue Service has issued additional information on the tax credit in [Notice 2010-44](#) and [Notice 2010-82](#), which provide guidance on determining eligibility for, calculating and claiming the credit. Also, more information about the credit, including [tax tips, guides](#) and [answers to frequently asked questions](#), is available on the IRS Web site, www.irs.gov.

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

This Fickewirth and Associates Legislative Brief describes the tax credit and explains which employers are eligible and how it can be claimed. Read below for more information on the tax credit.

OVERVIEW OF THE SMALL BUSINESS HEALTH CARE TAX CREDIT

The health care reform law includes the Patient Protection and Affordable Care Act, which was signed into law by President Obama on March 23, 2010, and the Health Care and Education Reconciliation Act of 2010, which was signed into law on March 30, 2010. These two laws together make sweeping changes to the nation's health care system, including many changes that affect employers.

One positive change for some small employers is a Federal income tax credit for health insurance premiums they pay for certain employees. The credit is available for tax years beginning in 2010.

Eligible Employers

The credit is specifically targeted to help small businesses and tax-exempt organizations that primarily employ low and moderate income workers. It is generally available to employers that have fewer than 25 full-time equivalent (FTE) employees, pay wages averaging less than \$50,000 per employee per year and maintain a "qualifying arrangement," as discussed below.

Notice 2010-82 provides the following additional information regarding eligible employers:

- 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.
- An employer that otherwise meets the requirements for the tax credit before January 1, 2014 may claim the credit even if its employees are not performing services in a trade or business.
- 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.

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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 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. 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.

The following employees are taken into account when counting an employer's FTEs:

- All non-excluded employees during the year for which the credit is being claimed, including former employees who terminated employment during the year, employees covered under a collective bargaining agreement and employees who do not enroll in the employer's health insurance plan.
- Leased employees (however, the premiums for health insurance coverage paid by a leasing organization for leased employees is not taken into account in calculating the amount of the credit).
- 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 employees are not considered in counting FTEs:

- Seasonal workers
- 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)
- Members of a business owner's family or household (including spouses)

Average Annual Wages

An employer's average annual wages is determined by first dividing (1) the total wages paid by the employer to employees who are taken into account for purposes of determining the number of an employer's FTEs during the employer's tax year (including overtime pay) by (2) the number of the employer's FTEs for the year, then rounding down to the nearest \$1,000.

An employer is permitted to use one of three methods to calculate employees' hours of service for the taxable year:

- Counting actual hours worked
- Using a days-worked equivalency
- Using a weeks-worked equivalency

The employer does not need to use the same method for all employees; different methods may be used for different classifications of employees. In addition, employers may change the method for calculating employees' hours of service for each taxable year.

Credit Amount

The maximum credit is 35 percent of premiums paid in 2010 for eligible small business employers and 25 percent of premiums paid for eligible employers that are tax-exempt organizations. In 2014, this maximum credit increases to 50 percent of premiums paid for taxable business employers and 35 percent of premiums paid for tax-exempt organizations.

The maximum credit goes to smaller employers — those with 10 or fewer FTEs — paying 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. Both small businesses and tax-exempt organizations will use new **Form 8941** to calculate the credit.

Only premiums paid by the employer under a qualifying arrangement are counted in calculating the credit. In computing the credit for a tax year beginning in 2010, employers may count all eligible premiums described for that tax year, including those paid before the health care reform law was enacted.

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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 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.

As explained in the next section, employer contributions to Health Reimbursement Arrangements (HRAs), health Flexible Spending Accounts (health FSAs) and Health Savings Accounts (HSAs) are not included in 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.

If an employer has employees in multiple states, the employer applies the average premium for the small group market in the state (or geographic location within the state) separately for each employee using the average premium for the state in which the employee works.

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 percent x \$72,000).

Qualifying Arrangements and Health Insurance Coverage

In order to be able to claim the credit, the employer must provide health insurance coverage to its employees through 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.

Notice 2010-82 clarified that 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.

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.

Notice 2010-82 specifically indicates that 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 through 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."

Notice 2010-44 provides transition relief in applying the uniformity requirement for tax years beginning in 2010. Under these 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.

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Example: For the 2010 tax year, an eligible small employer has 9 FTEs with average annual wages of \$23,000 per FTE. Six employees are enrolled in single coverage and 3 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 6 employees enrolled in single coverage and \$4,000 of the premium for each of the 3 employees enrolled in family coverage. The employer is deemed to satisfy the uniformity requirement for a qualifying arrangement under the transition relief rule.

Notice 2010-82 provides rules for applying the uniformity requirement for the 2010-2013 tax years. For tax years beginning in 2010, employers can choose between the requirements of Notice 2010-82 or Notice 2010-44. The Notice 2010-82 requirements that apply 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.

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. 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 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 at least 66 percent of the self-only composite rate for each not-reference plan for which the employer is claiming the credit.

How to Claim the Credit

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. Tax-exempt employers will claim the small business health care tax credit on a revised Form 990-T. The Form 990-T is currently used by tax-exempt employers to report and pay the tax on unrelated business income. Form 990-T will be revised for the 2011 filing season to enable eligible tax-exempt organizations – even those that owe no tax on unrelated business income – also to claim the small business health care tax credit. Employers (other than tax-exempt employers) generally cannot claim the credit unless they have taxable income 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.

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