

IRS releases preliminary guidance on small business health care credit in new health reform law

IR 2010-38

IRS website *Small Business Health Care Tax Credit fact sheet, scenarios, and FAQs:*
<http://www.irs.gov/newsroom/article/0,,id=220848,00.html?portlet=7>

Reacting quickly to health reform legislation passed by Congress and signed into law by the President just a few days ago, IRS has issued preliminary guidance on the small employer health insurance credit created by the Patient Protection and Affordable Care Act (Health Care Act, P.L. 111-148). This complex credit offers immediate relief to small businesses (generally, those employing fewer than 25 full time equivalent workers earning average wages of less than \$50,000 per employee) that pay at least 35% (25% for exempts) of employees' health premiums, rising to 50% in 2014 (35% for exempts).

Background. For tax years beginning after Dec. 31, 2009, the Health Care Act provides a tax credit for an eligible small employer (ESE) for nonelective contributions to purchase health insurance for its employees. (Code Sec. 45R) An eligible small employer (ESE) for this purpose generally is an employer with no more than 25 full-time equivalent employees (FTEs) employed during its tax year, and whose employees have annual full-time equivalent wages that average no more than \$50,000. (Code Sec. 45R(d)) However, the full amount of the credit is available only to an employer with 10 or fewer FTEs and whose employees have average annual full-time equivalent wages from the employer of less than \$25,000. (Code Sec. 45R(c))

The contributions must be provided under an arrangement that requires the eligible small employer to make a nonelective contribution on behalf of each employee who enrolls in certain defined qualifying health insurance offered to employees by the employer equal to a uniform percentage (not less than 50%) of the premium cost of the qualifying health plan. (Code Sec. 45R(d)(4))

The credit is a general business credit, and can be carried back for one year and carried forward for 20 years. (Code Sec. 38(b), Code Sec. 39(a)) The credit is available for tax liability under the alternative minimum tax. (Code Sec. 38(c)(4)(B)(vi))

Year the credit is available. The credit is initially available for any tax year beginning in 2010, 2011, 2012, or 2013. Qualifying health insurance for claiming the credit for this first phase of the credit is health insurance coverage within the meaning of Code Sec. 9832(b)(1). (Code Sec. 45R(g)(2)) This is generally health insurance coverage purchased from an insurance company licensed under State law.

For tax years beginning in years after 2013, the credit is only available to an eligible small employer that purchases health insurance coverage for its employees through a State exchange and is only available for a maximum coverage period of two consecutive tax years beginning with the first year in which the employer or any predecessor first offers one or more qualified plans to its employees through an exchange. (Code Sec. 45R(d)(4))

Calculation of credit amount. The credit is equal to the lesser of the following two amounts multiplied by an applicable tax credit percentage: (1) the amount of contributions the ESE made on behalf of the employees during the tax year for the qualifying health

coverage and (2) the amount of contributions that the employer would have made during the tax year if each employee had enrolled in coverage with a small business benchmark premium. (Code Sec. 45R(b)) To calculate the contributions under the second of these two amounts, the benchmark premium is multiplied by the number of employees enrolled in coverage and then multiplied by the uniform percentage that applies for calculating the level of coverage selected by the employer. (Committee Report)

The applicable percentage is 35% for tax years beginning in after 2009 and before 2014. It is 50% for tax years beginning after 2013. (Code Sec. 45R(b))

The credit is reduced for employers with more than 10 FTEs but not more than 25 FTEs. It is also reduced for an employer for whom the average wages per employee is between \$25,000 and \$50,000. (Code Sec. 45R(c))

Tax-exempt 501(c) organizations are allowed the credit in a lesser amount against certain payroll taxes. (Code Sec. 45R(f))

Special rules. The credit reduces the employer's deduction under Code Sec. 162 for contributions. (Code Sec. 45R(e)(5))

Aggregation rules apply in determining the employer. (Code Sec. 45R(b))

Self-employed individuals, including partners and sole proprietors, 2% shareholders of an S Corporation, and 5% owners of the employer (within the meaning of Code Sec. 416(i)(1)(B)(i)) are not treated as employees for purposes of this credit. Any employee with respect to a self employed individual is not an employee of the employer for purposes of this credit if the employee is not performing services in the trade or business of the employer. Thus, the credit is not available for a domestic employee of a sole proprietor of a business. There is also a special rule to prevent sole proprietorships from receiving the credit for the owner and their family members. (Code Sec. 45R(e)(1); Committee Report)

New guidance. IRS uses a series of FAQs to explain and illustrate many aspects of the intricate new credit, including the following rules that apply to employers other than exempts.

Expenses that count in calculating the credit. Only premiums paid by the employer under a qualifying arrangement count in calculating the credit. In a qualifying arrangement, the employer pays premiums for each employee enrolled in health care coverage the employer offers in an amount equal to a uniform percentage (not less than 50%) of the premium cost of the coverage. If an employer pays only a portion of the premiums for 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% of the premiums for employees' coverage (with employees paying the other 20%), only the 80% premium amount paid by the employer counts in calculating the credit. (FAQ 3)

IRS says that in forthcoming guidance intended to make it easier for taxpayers to meet the requirements for a qualified arrangement for tax years beginning in 2010, it will spell out that:

1. An employer that pays at least 50% of the premium for each employee enrolled in coverage offered to employees by the employer won't fail to maintain a qualifying

arrangement merely because the employer does not pay a uniform percentage of the premium for each such employee. If the employer otherwise satisfies the credit requirements, it will qualify for the credit even though the percentage of the premium it pays is not uniform for all such employees.

2. 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. So if Employee A gets single coverage, the employer satisfies the 50% requirement for A if it pays at least 50% of the premium for that coverage. If Employee B gets coverage that is more expensive than single coverage (such as family or self-plus-one coverage), the employer satisfies the 50% requirement for B 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). (FAQ 22)

For purposes of the credit (including the 50% requirement), any premium paid pursuant to a salary reduction arrangement under a Code Sec. 125 cafeteria plan is not treated as paid by the employer. In addition, the amount of an employer's premium payments that counts for Code Sec. 45R purposes is capped by the premium payments it 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. (FAQ 3)

If the employer pays only part of the premium for health coverage (e.g., it pays 80% of the premiums and the employees pay the other 20%), the premium amount that counts for purposes of the credit is the same portion (80% 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. 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 IRS. Publication of the average premium for the small group market on a State-by-State basis is expected to be posted on IRS's website by the end of April. (FAQ 4)

Figuring the number of FTEs. 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. (Code Sec. 45R(d)(2)) The result, if not a whole number, is then rounded to the next lowest whole number.

Illustration: For the 2010 tax year, ABC 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. ABC's FTEs are calculated as follows:

Total hours not exceeding 2,080 per employee is the sum of:

(1) 10,400 hours for the 5 employees paid for 2,080 hours each (5 x 2,080),

(2) 3,120 hours for the 3 employees paid for 1,040 hours each (3 x 1,040); and

(3) 2,080 hours for the 1 employee paid for 2,300 hours (lesser of 2,300 and 2,080)

These add up to 15,600 hours.

ABC has 7 FTEs ($15,600 \div 2,080 = 7.5$, rounded to the next lowest whole number). (FAQ 9)

Because the limit on the number of employees is based on FTEs, an employer with 25 or more employees may qualify for the credit if some of its employees are part-timers. For example, an employer with 46 half-time employees (i.e., paid wages for 1,040 hours) has 23 FTEs and therefore may qualify for the credit. However, seasonal workers are disregarded in determining FTEs and average annual wages unless they work for the employer on more than 120 days during the tax year. (FAQs 11 and 12)

Excluded employees. Under Code Sec. 45R(e), a sole proprietor, a partner in a partnership, a shareholder owning more than 2% of an S corporation, and any owner of more than 5% of other businesses are not considered employees for purposes of the credit. Additionally, a family member of any of these individuals, or a member of such a business owner's or partner's household, is not considered an employee for purposes of the credit. The wages or hours of these business owners and partners and their family or household members 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. (FAQs 13 and 14)

Calculating average annual wages. 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). Code Sec. 45R(d)(3)(A)) For this purpose, wages means wages as defined for FICA purposes (without regard to the wage base limitation). (Code Sec. 45R(e))

Illustration: For the 2010 tax year, XYZ \$224,000 in wages and has 10 FTEs. XYZ's average annual wages for Code Sec. 45R purposes are \$22,000 ($\$224,000$ divided by 10 = $\$22,400$, rounded down to the nearest \$1,000). (FAQ 10)

Credit phaseout. 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 having as the numerator the number of FTEs in excess of 10, and having 15 as the denominator.
- If average annual wages exceed \$25,000, the reduction is determined by multiplying the otherwise applicable credit amount by a fraction having as the numerator the amount by which average annual wages exceed \$25,000, and having \$25,000 as the denominator. (Code Sec. 45R(c))

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. (FAQ 7)

Illustration: For the 2010 tax year, Widget, Inc., a qualified employer, has 12 FTEs and average annual wages of \$30,000. Widget 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 Code Sec. 45R requirements.

Widget's credit is \$22,400, 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: ($\$33,600 \times 2/15$)
= \$4,480.

(3) Credit reduction for average annual wages in excess of
\$25,000: ($\$33,600 \times \$5,000/\$25,000$) = \$6,720.

(4) Total credit reduction: ($\$4,480 + \$6,720$) = \$11,200.

(5) Total 2010 tax credit: ($\$33,600 - \$11,200$) = \$22,400.
(FAQ 7)

Premiums paid earlier in 2010 count. For purposes of figuring the Code Sec. 45R credit for a tax year beginning in 2010, employers may count all qualifying premiums for the year, even premiums paid before the new health reform law was enacted. (FAQ 8)

Claiming the credit. The Code Sec. 45R credit is claimed on an employer's annual income tax return and may be taken into account in determining estimated tax payments for the year. (FAQs 18 and 19) 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. (FAQ 20)

IRS says it will use postcards to notify the "millions of small businesses" that may qualify for the credit.

Source: Federal Tax Updates on Checkpoint Newsstand tab 4/2/2010