



Small Business Tax Credit For Healthcare Now Available

Insights

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As part of the Patient Protection and Affordable Care Act (PPACA) signed into law by President Obama on March 23, 2010, small businesses now have reason to consider offering health insurance coverage for the first time or to continue maintaining existing coverage for their employees. The enticement? A new special tax credit that takes effect immediately.

The tax credit specifically targets "eligible small employers," including Code section 501(c) tax-exempt organizations. To be considered an "eligible small employer" for purposes of the tax credit, an employer must:

1. employ fewer than 25 full-time equivalent employees (FTEs) for a tax year;
2. pay wages averaging less than \$50,000 per employee per year (for taxable years beginning in 2010 through 2013); and
3. provide health care coverage under a "qualifying arrangement."

Small employers with 10 or fewer FTEs who pay annual average wages of \$25,000 or less will be entitled to receive the maximum credit. Small employers with more than 10 FTEs or with average annual wages that exceed \$25,000 (but less than \$50,000) will be entitled to a reduced credit (but not below zero). Members of a controlled group or an affiliated service group will be treated as a single employer for purposes of the tax credit.

The credit can be claimed on the employer's annual income tax return, and applies against income taxes, not employment taxes. If an employer (other than a tax-exempt employer) has no taxable income for the year, the employer generally cannot claim the credit for the year because the credit is designed to offset actual income tax liability (or alternative minimum tax liability) for the year.

That said, generally an unused business tax credit can be carried back one year or carried forward 20 years as a general business tax credit. The IRS has indicated that any unused credit amount for 2010 can only be carried forward (but not back one year) because an unused credit cannot be carried back to a year before the effective date of the establishment of the credit.

Caution – Determining The Tax Credit Can Be Tricky!

First, to determine the number of FTEs for purposes of determining eligibility to claim the credit, divide the total hours for which the employer pays wages to employees during the year (to a maximum of 2,080 hours for any employee) by 2,080. The result should then be rounded down to the next lowest whole number, if not already a whole number.

Because the tax credit is determined on the basis of FTEs rather than the actual number of employees, an employer with more than 25 employees may potentially still be able to qualify for the credit if some of its employees are part-time. Generally, however, seasonal workers should be disregarded in calculating FTEs (and average annual wages) unless they work for more than 120 days during the tax year.

In addition, a sole proprietor, a partner in a partnership, a shareholder owning more than 2 percent of an S-corporation, and any owner of more than 5 percent of other businesses should not be counted as an employee in determining the employer's total FTEs or average annual wages for purposes of the tax credit, nor should family members of a business owner who work for the business.

Second, to determine average annual wages, divide the total wages paid to employees during the employer's tax year by the number of the employer's FTEs for the year. Again, the result should be rounded down, but this time to the nearest \$1,000, if not otherwise a multiple of \$1,000. Also note that in determining wages, employers should use the definition of wages used for FICA purposes, disregarding the wage base limitation in effect for the tax year.

For example: Assume that an employer employs eight full-time employees and two part-time employees (10 FTEs) and the employer's total wages for those 10 employees for the 2010 tax year equals \$240,750. The employer rounds down the total wages to the nearest multiple of \$1,000 (or \$240,000), so that average annual wages total \$24,000 (\$240,000 divided by 10 FTEs). Assume further that the employer's health care costs for 2010 equal \$70,000. In this case, the employer will be entitled to the maximum tax credit available in 2010 (or 35%). The employer is, therefore, entitled to a tax credit against its income tax liability for 2010 in the amount of the \$24,500 (\$70,000 multiplied by 35%).

What Constitutes A "Qualifying Arrangement"?

Under Code section 45R, a qualifying arrangement is an arrangement where the eligible small employer makes non-elective contributions on behalf of each employee who enrolls in a health plan offered by the employer in an amount equal to a uniform percentage (but not less than 50%) of the premium cost for the coverage.

Premiums paid under a section 125 cafeteria plan pursuant to a salary-reduction agreement are not treated as paid by the employer (and so should be ignored) in determining an employer's non-elective contributions for purposes of the credit and the 50% requirement. For example, if an

elective contributions for purposes of the credit and the 50% requirement. For example, if an employer pays only 80 percent of the premiums and employees pay the remaining 20 percent through salary reduction under a section 125 cafeteria plan, only the 80 percent paid by the employer counts in calculating the credit.

To add more confusion to the mix, the amount of an employer's premium payments counted for purposes of the credit is capped. An employer must determine what the average premium cost of a like arrangement offered in the small group market in your state (or an area within the state) would be, and if less than your actual premium, must substitute the state's average premium in place of the employer's actual premium. So how does one determine the average premium cost in the small group market for the state? Well, the IRS anticipates providing a publication of the average premiums for the small group market on a state-by-state basis at the end of April, and it will be available on their [website](#).

So Is All The Confusion Worth It?

You bet! The tax credit is worth up to 50% of premiums paid, over time. However, the tax credit that can be claimed by an eligible small employer differs, depending upon whether the small employer is a for-profit entity or a tax-exempt organization. The maximum tax credit available to a for-profit eligible small business employer in 2010 is 35% of the premiums paid. Eligible tax-exempt employers, on the other hand, are entitled to a maximum tax credit of 25% of premiums paid in 2010. In 2014, the maximum credit will increase to 50% of premiums paid by for-profit eligible small business employers and 35% of premiums paid by eligible tax-exempt organizations.

For tax years beginning in 2010, the IRS and Treasury intend to issue transitional relief so that employers who do not pay a uniform percentage of their employee premiums currently will not be considered to fail to maintain a qualifying arrangement and so may still qualify for the tax credit in 2010.

For more detailed information regarding this new small business health care credit, whether you qualify for it, how to calculate it, or for assistance regarding any of your employee benefits questions, please contact one of the attorneys in our Employee Benefits Practice Group.