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HEALTHCARE REFORM

NEW TAX CREDIT FOR SMALL EMPLOYERS' HEALTH INSURANCE EXPENSES

The Healthcare Reform Act provides a tax credit for small employers to assist with the cost of providing health insurance for their employees. The tax credit is in effect from 2010 through 2013.

Background and Guidance

On March 23, 2010, President Obama signed the Patient Protection and Affordable Care Act, and on March 30, 2010, he signed the Health Care Reconciliation Act (referred to collectively as the "Healthcare Reform Act"). The Healthcare Reform Act added a new section 45R to the Internal Revenue Code to provide an income tax credit for employee health insurance expenses of small employers for taxable years beginning in 2010 through taxable years beginning in 2013. On June 1, 2010, the Internal Revenue Service issued Notice 2010-44, which provides guidance on which employers qualify for the credit, how to calculate the credit, the phase out of the credit, and a transition rule for 2010.

Generally, the tax credit is available if (1) the employer has fewer than 25 full-time equivalent employees (FTEs) for the taxable year, (2) the average annual wages per FTE for the taxable year is less than \$50,000, and (3) the employer maintains a "qualifying arrangement" for the taxable year. The credit is fully available to an employer with 10 FTEs and average annual wages of \$25,000. The credit phases out pro rata so that an employer with 25 FTEs with average annual wages of \$50,000 is not entitled to the credit.

Number of Employees for the Taxable Year

The number of FTEs is determined by first counting all employees who perform services for the employer at any time during the taxable year. Generally, sole proprietors, partners in a partnership, more than 2 percent shareholders of an S corporation, and more than 5 percent owners of any other business are not included in the count. In addition, seasonal workers who work fewer than 120 days in the year are not counted.

Next, determine the number of hours that each employee who is included in the count works during the taxable year, but not more than 2080 hours for any employee. Generally, count hours for which the employee is paid for working and hours for which the employee is paid for time off, such as vacation, holidays, sick leave, incapacity (including disability), jury duty, military leave or leave of absence. No more than 160 hours may be counted for a single continuous period of paid time off. If the employer does not keep a record of hours worked, it can use a days-worked (8 hours for each day) or a weeks-worked (40 hours for each week) equivalency for each day or week in which the employee worked at least one hour.

Determine the number of FTEs by dividing the total number of hours worked by each employee taken into account under the first paragraph of this section by 2080. A fraction is rounded down to the next whole number. For example, if the employer had five full-time employees and three part-time employees, and the eight employees worked a total of 15,600 hours in the taxable year, the employer has seven FTEs (15,600 divided by 2080 equals 7.5, which is rounded down to 7).

Average Annual Wages per FTE for the Taxable Year

Determine the average annual wages by dividing (1) the total wages paid by the employer for the taxable year to the employees counted for purposes of determining the number of FTEs by (2) the number of FTEs for the year, and (3) rounding the result down to the nearest \$1,000. For example, if the employer pays \$224,000 in total wages for the taxable year and has 10 FTEs, it pays average annual wages per FTE of \$22,000 (\$224,000 divided by 10 equals \$22,400, which is rounded down to the nearest \$1,000).

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Qualifying Arrangement

The credit is available only for premiums paid by the employer under a qualifying arrangement. The health plan is a qualifying arrangement if the employer pays a uniform percentage (but not less than 50%) of the premium.

For purposes of the credit, health insurance includes group health coverage as well as certain limited scope coverage such as limited scope dental or vision, long-term care, nursing home care, home health care, community-based care, coverage for a specific disease or illness, hospital indemnity or other fixed indemnity insurance, Medicare supplemental insurance, and certain other supplemental coverage. Employer-paid premiums for any of this coverage can be included in determining the credit.

Employer premiums for coverage that is not subject to the HIPAA special enrollment and creditable coverage requirements may not be included in determining the credit.

In addition, if the employer maintains separate plans, for example, a separate group medical plan and a separate dental plan, each plan must satisfy these requirements separately. For example, if the employer pays 75 percent of the group medical premiums and 25 percent of the dental premiums, only the premiums under the group medical plan are eligible for the credit even if the employer pays at least 50 percent of the premiums under both plans in the aggregate.

In addition, the amount of the aggregate employer-paid premiums that can be used in calculating the credit is limited to the average premium for the small group market in the employer's state. The premiums for 2010 are listed state by state in IRS Revenue Ruling 2010-21. The premiums in the small group market cap the aggregate premiums paid by the employer; the cap does not apply to each plan individually.

Transition Relief for 2010. Because the credit applies to 2010, including premiums paid by the employer before the Healthcare Reform Act became law, the Notice provides relief for premium arrangements in 2010. If the employer pays at least 50 percent of the premium for single coverage, it will be deemed to satisfy the uniformity requirement if the employer-paid amount for coverage that is more expensive than single coverage is at least 50 percent of the cost of single coverage. For example, if the premium for single coverage is \$8,000 and the premium for family coverage is \$14,000, and if the employer pays 50 percent of the premium for single coverage (or \$4,000), then so long as it pays at least \$4,000 of the premium for family coverage, it will be deemed to satisfy the uniformity requirement even though \$4,000 is less than 50 percent of \$14,000.

Determining the Credit

For taxable employers, the maximum credit is 35 percent of the employer's premium payments that can be taken into account. For a tax exempt employer, the credit is 25 percent. And, a tax exempt employer's credit cannot exceed the sum of the amount of required income tax withholding and Medicare tax plus employer's share of the Medicare tax.

The credit phases out if the number of FTEs is greater than 10 and/or the average wage per FTE exceeds \$25,000.

The reduction has two parts: a reduction if the number of FTEs is greater than 10 and a reduction if the average wage is greater than \$25,000. If the number of FTEs is greater than 10, the credit is reduced by a fraction, the numerator of which is the number of FTEs over 10 and the denominator of which is 15. If the average wage exceeds \$25,000, the credit is reduced by a fraction, the numerator of which is the amount of wages over \$25,000 and the denominator of which is \$25,000. If both reductions apply, each amount is subtracted from the credit.

For example, if a taxable employer has 12 FTEs, average wages of \$30,000, and an initial credit of \$33,600, the reductions are determined as follows:

- reduction for FTEs over 10: $2/15$ times \$33,600 equals \$4,480
- reduction for average wages over \$25,000: $5,000/25,000$ times \$33,600 equals \$6,720

The total reduction is \$11,200 (\$4,480+\$6,720) and the allowable credit is \$22,400.

Effect of State Credits and State Premium Payments

The Notice provides that a State's payments to an employer to subsidize premium payments, a State's direct payments to an insurer, and state tax credits will not prevent the employer from satisfying the uniformity requirement and will not generally reduce the federal tax credit under section 45R. However, the amount of the federal tax credit under section 45R may not exceed the employer's "net premium payments." Where the state pays the subsidy directly to the employer or the employer has a state tax credit, the subsidy and/or the tax credit are subtracted from the premiums paid by the employer to determine the "net premium." Where the state pays the insurance company directly, the "net premium" is the amount actually paid by the employer.

Claiming the Credit

A taxable employer treats the credit as a general business credit, claims it on the employer's tax return, and offsets its tax liability for the taxable year by the amount of the credit. The credit can be used to reduce estimated tax payments for the year and, in some cases, the employer's alternative minimum tax liability. No deduction is allowed under section 162 for the amount of the health insurance premiums the employer pays that is equal to the amount of the credit.

The Notice provides that the IRS will provide further information on how a tax exempt employer can claim the credit.

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