



THE SMALL BUSINESS HEALTHCARE TAX CREDIT – DO YOU QUALIFY? HEALTHCARE REFORM IN AMERICA – Part VI

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*THIS EDITION OF OUR SERIES – **HEALTHCARE REFORM IN AMERICA** WILL REVIEW THE SMALL BUSINESS HEALTHCARE TAX CREDIT PROVISIONS OF THE **AFFORDABLE CARE ACT** (THE ACT) THAT BEGIN TO APPLY FOR THE 2010 TAX YEAR. WE WILL SUMMARIZE THE QUALIFICATION REQUIREMENTS AND EXPLAIN HOW THE HEALTHCARE CREDIT WILL WORK. WE PROVIDE **EXAMPLES** AT THE END OF THIS **INSIGHTS** TO HELP YOU DETERMINE IF YOU QUALIFY FOR THE CREDIT AND TO SHOW HOW THE CREDIT IS CALCULATED FOR THE 2010 TAX YEAR.*

The Internal Revenue Service issued *NOTICE 2010-44* that provides guidance on the determination of the healthcare tax credit. This notice can be found at <http://www.irs.gov/pub/irs-drop/n-10-44.pdf>

WHAT THE LAW STATES

Small employers that provide healthcare benefits may be eligible for a tax credit beginning with the 2010 tax year. To qualify for the tax credit, an employer must:

- ◆ Employ no more than 25 *full-time equivalent employees (FTEs)*, and
- ◆ Have *average annual wages* not greater than \$50,000, and
- ◆ Maintain a “*qualifying arrangement*”, defined as an arrangement where the employer is paying a uniform percentage of health insurance costs (not less than 50%) for each enrolled employee. **For the 2010 tax year only**, an employer who pays at least 50% of the single premium for each employee enrolled under the plan will be considered to maintain a qualifying arrangement in 2010.

The credit may be applied to medical plans and other employer-sponsored coverage such as dental and vision. However, each plan must independently be considered a qualifying arrangement (the employer pays at least 50%

toward the cost of coverage). For example, if an employer contributes 80% toward the cost of medical coverage and 40% toward the cost of dental coverage, the credit will be determined based only on the employer’s share of medical plan costs.

Other types of arrangements that qualify for the credit include long-term care, nursing home care, home health care, community-based care, disease-specific coverage and Medicare supplemental health insurance.

Employer contributions to Health Reimbursement Arrangements (HRAs), Health Savings Accounts (HSAs) and employee salary reduction amounts under a Flexible Spending Account do not appear to qualify as employer expenses for the tax credit.

THE TAX CREDIT

The maximum tax credit for the 2010 through 2013 tax years is equal to 35% of the lesser of:

- ◆ The employer’s share of healthcare premium costs, or
- ◆ The average premium for the small group market in the state in which the employer is offering coverage. This amount represents the overall limit applied to all qualifying arrangements, in total, and is not applied separately to each line-of-coverage that qualifies for a tax credit.

Revenue Ruling 2010-13 sets forth the 2010 small group market average premium rates, which can be found at the following IRS website <http://www.irs.gov/pub/irs-drop/rr-10-13.pdf>

It should be noted that the Secretary of Health and Human Services (HHS) can determine whether these state-wide average premium rates should be further divided among sub-state areas to address cost disparities in different regions of a single state.

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The maximum 35% tax credit is available to small employers with up to 10 employees who have average annual wages of up to \$25,000. The maximum tax credit will be reduced as the number of FTEs increases above 10 or average-annual wages increases above \$25,000. For example, an employer with 26 FTEs and average annual wages of \$20,000 will not qualify for the credit. Similarly, an employer with 10 FTEs and average annual wages of \$55,000 will also be ineligible for the tax credit.

A maximum 25% credit is available for tax-exempt employers, as well. However, the credit cannot exceed the total amount of income tax withheld plus the total Medicare tax (employee and employer) amounts.

The tax credit will be applied against an employer's tax liability, or against payroll tax liability for tax-exempt organizations. Those employers who take advantage of the tax credit will not be allowed to claim a corresponding tax deduction for these costs.

ELIGIBILITY DETERMINATION

The law and subsequent guidance provided in IRS Notice 2010-44 outlines the steps to follow to determine if an employer qualifies for the credit which include:

- Determine the employees to recognize for the calculation,
- Calculate the number of hours of service performed by these employees,
- Calculate the number of FTEs in accordance with IRS guidance,
- Determine the average annual wages paid per FTE, and
- Determine the premiums paid by the employer for the applicable employee population.

A DETAILED EXAMPLE AT THE END OF THIS INSIGHTS WILL ILLUSTRATE THE REQUIRED COMPUTATION FOR EACH OF THE STEPS NOTED ABOVE.

EMPLOYEES RECOGNIZED IN THE CALCULATION

In general, any employee who performs paid services, (including part-time employees for whom benefits may not be provided), for an employer in the taxable year will need to be included in the population and average annual compensation determination. However, certain individuals are excluded from all calculations, and the corresponding employer share of premium costs (associated with these excluded individuals) may not be

considered in the tax credit calculation. Individuals who are excluded from the determination are:

- Seasonal workers who work less than 120 days,
- Sole proprietors,
- Partners in a partnership,
- Shareholders owning more than 2% of an S-Corporation,
- Owners of more than 5% of other businesses, and
- Family members of owners and partners defined as: children (and descendants), siblings, parents, nieces, nephews, aunts, uncles, and in-laws.

All employees of a controlled group of corporations or an affiliated service group are treated as being employed by a single employer.

HOURS OF SERVICE AND FULL-TIME EQUIVALENT EMPLOYEES

In order to determine the number of FTEs, an employer must consider the total annual hours of service (to a maximum of 2,080) performed by the workforce included in the determination. The IRS has set forth three acceptable methods to compute hours of service which include:

- Actual hours of service based on employer records,
- Days-worked equivalency where an employee is credited with 8 hours for each day, or
- Weeks worked equivalency where an employee is credited with 40 hours of service for each week worked.

The total hours of workforce service is then divided by 2,080 to calculate the number of *full-time equivalent employees*.

AVERAGE ANNUAL WAGES

To determine the *average annual wages*, an employer must aggregate the total wages for the applicable population for the tax year, divide the result by the number of FTEs calculated above and round this result down to the nearest \$1,000. Wages paid for service in excess of 2,080 hours are disregarded in the calculation.

Wages are defined as under IRC section 3121(a) for purposes of Federal Insurance Contributions Act (FICA) without regard to any wage base limitation. Wages would include all forms of cash wages as well as cash tips in excess of \$20 per month. Salary reduction amounts for qualified pension arrangements and cafeteria plans would be excluded.

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EMPLOYER PREMIUMS

The annual employer premium for each *qualifying arrangement* is also needed. A few points to remember:

- ◀ The annual premium for all *qualifying arrangements* (such as medical and dental) must be aggregated before comparing to the maximum average state premium.
- ◀ Only include the applicable premium costs for those employees included in the calculations. Costs for owners and shareholders, for example, would not be reflected when calculating the tax credit.

SUMMARY

Employers who believe they may be eligible for the tax credit should begin to review employment records in order to properly track the number of hours worked, as well as wage and premium data. Employers should begin to consult with tax advisors to discuss potential eligibility for the credit and to estimate its impact. This tax credit (and the rules for determining the amount of the credit) will be in effect through the 2013 tax year as indicated in IRS Notice 2010-44. The maximum credit will increase to 50% (35% for tax-exempt employers) for tax years that begin after 2013, will only be available for two years, and will be limited to those employers who purchase coverage from the Exchange.

PLEASE REFER TO THE DETAILED EXAMPLE AT THE END OF THIS INSIGHTS THAT WILL ILLUSTRATE THE SMALL BUSINESS TAX CREDIT COMPUTATION.

ADDITIONAL INFORMATION

For specific questions concerning information contained in this *Insights*, please contact your Chernoff Diamond consultant.

Information contained in this *Insights* is not intended to render tax or legal advice. Employers should consult with qualified legal and/or tax counsel for guidance in respect of matters of law, tax and related regulation.

Chernoff Diamond provides comprehensive consulting and administrative services with respect to all forms of employee benefits, risk management and qualified and non-qualified retirement plans.

For additional information about our services please contact us at (516) 683-6100 or via e-mail at mail@chernoffdiamond.com.

EXAMPLE – CALCULATING THE SMALL BUSINESS HEALTHCARE TAX CREDIT

XYZ COMPANY QUALIFIES FOR THE SMALL BUSINESS HEALTHCARE TAX CREDIT FOR 2010

XYZ COMPANY - Assumptions

- 10 full-time employees who work 35 hours per week each with annual salary of \$35,000.
 - 4 with single coverage (medical and dental)
 - 5 with family coverage (medical and dental)
- 20 part-time employees who work 15 hours per week with no benefits and earn \$15 per hour
- 2 owners who work 45 hours per week with annual earnings of \$150,000 and family coverage.
- A New York employer.

XYZ COMPANY offers medical and dental coverage and pays 70% of medical costs and 50% of dental costs. Both plans are qualifying arrangements. The annual premiums are as follows:

	Annual Medical Premium	Annual Dental Premium	Total Annual Premium	NY State Maximum Annual Premium
Single	\$5,000	\$400	\$5,400	\$5,442
Family	\$12,500	\$1,000	\$13,500	\$12,867

Step 1 – DETERMINE THE EMPLOYEES TO RECOGNIZE

XYZ COMPANY would base the calculation on 10 full-time and 20 part-time employees. The owners are excluded from the determination.

Step 2 – CALCULATE THE HOURS OF SERVICE

XYZ COMPANY would calculate Hours-Of-Service as:
 10 FT employees x 35 hours per week x 52 weeks = 18,200,
 plus
 20 PT employees x 15 hours per week x 52 weeks = 15,600
Total Hours Worked= 18,200 + 15,600 = 33,800

Step 3 – DETERMINE FULL-TIME EQUIVALENT EMPLOYEES

XYZ COMPANY would have $33,800 \div 2,080 = 16$ FTEs (the result is rounded down to the next lowest number)

Step 4 – DETERMINE AVERAGE ANNUAL WAGES

XYZ COMPANY would have average annual wages of:
 10 FT employees x \$35,000 = \$350,000
 plus
 20 PT employees @ 15,600 hours x \$15 = \$234,000
XYZ COMPANY has average annual wages of
 $[\$350,000 + \$234,000] = \$584,000 \div 16 \text{ FTEs} = \$36,000$
 (the result is rounded down to the next lowest \$1,000)

Step 5 – DETERMINE THE APPLICABLE ANNUAL PREMIUM

4 single = $4 \times [\$5,000 \times 70\% + \$400 \times 50\%] = \$14,800$

Family coverage is limited to the state maximum
 5 family = $5 \times \$12,867 = \$64,335$ (total cost)

Prorate family coverage for employer portion of the costs

Medical = $\$64,335 \times [\$12,500 \div \$13,500] \times 70\% = \$41,669$
 Dental = $\$64,335 \times [\$1,000 \div \$13,500] \times 50\% = \$2,382$
 Family premium = $\$41,669 + \$2,382 = \$44,081$

XYZ COMPANY premium is $\$14,800 + \$44,081 = \$58,881$

It should be noted that IRS guidance did not provide an example whereby two qualifying arrangements have different employer contribution percentages and the combined premium exceeds the state maximum. The above example would appear to be an acceptable calculation method.

Step 6 – CALCULATE THE MAXIMUM CREDIT

XYZ COMPANY maximum credit is $35\% \times 58,881 = \$20,608$

Step 7 – REDUCTION FOR FTES GREATER THAN 10

The maximum credit (STEP 6) is reduced by a percentage which is the number of FTEs (STEP 3) greater than 10 divided by 15. The reduction for XYZ COMPANY would be as follows:

$(16 \text{ FTEs} - 10) \div 15 \times \$20,608 = \$8,243$

Step 8 – REDUCTION FOR AVERAGE WAGES GREATER THAN \$25,000

The maximum credit (STEP 6) is reduced by a percentage which is the average annual wages (STEP 4) greater than \$25,000 divided by \$25,000. The reduction for XYZ COMPANY would be as follows:

$(\$36,000 - \$25,000) \div \$25,000 \times \$20,608 = \$9,068$

Step 9 – AND FINALLY XYZ COMPANY 2010 CREDIT

The small business tax credit for XYZ COMPANY for 2010 would be STEP 6 – STEP 7 – STEP 8
 $\$20,608 - \$8,243 - \$9,068 = \$3,297$

This example is for illustrative purposes only and is not intended to render tax advice. Employers and plan sponsors should seek guidance from qualified tax advisors for matters regarding the Small Business Tax Credit discussed herein.