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The Small Employer Tax Credit

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Under the new health care reform law, small employers meeting certain requirements are considered “qualified employers” and may be eligible for a federal income tax credit for the health insurance premiums they pay for employees. Although not specifically addressed in the IRS guidance, the legislative history of health care reform indicates that clients of PEOs meeting the requirements of a qualified employer will be eligible for the tax credit. (NAPEO’s position paper, “PEO Client Access to Federal Tax Credit Under Patient Protection and Affordable Care Act (PPACA), is available to NAPEO members at <http://snipurl.com/26p68j>.) To provide guidance to PEOs that may be assisting their clients in determining whether the tax credit is available, the following provides an overview of the requirements for determining whether employers are qualified employers for purposes of the tax credit and guidelines for calculating the tax credit.

Qualified Employer Determination

A qualified employer is an employer that has fewer than 25 full-time equivalent employees (FTEs) for the tax year, pays average annual wages to its employees for the year of less than \$50,000 per FTE, and pays health care premiums on behalf of its employees under a “qualifying arrangement.”

Determining the Number of Full-Time Equivalent Employees

Determining whether an employer is a qualified employer is based on the number of FTEs, not the number of employees. Employers that use part-time workers may qualify as qualified employers even if they employ more than 25 individuals.

To calculate the number of FTEs, divide the total “hours of service” for which the employer pays wages to employees during the year (but not more than 2,080 hours for any one employee) by 2,080. Round the result to the next lowest whole number, unless the result is less than one, in which case, round up to one.

Generally, all employees of the controlled group or affiliated service group are taken into account for purposes of calculating the number of FTEs. However, seasonal workers who work fewer than 120 days during the tax year, and certain owners, including sole proprietors, partners in a partnership, shareholders owning more than 2 percent of an S-corporation, and any owner who is a more than 5 percent owner of any other types of business entities and their family members are disregarded when determining the number of FTEs.

For purposes of this calculation, “hours of service” includes each hour for which an employee is paid, or entitled to payment by the employer, for the performance of duties during the employer’s tax year. Hours of service also include each hour paid for the nonperformance of service, such as vacation or other paid leave, except that no more than 160 hours of service are required to be counted on account of any single continuous period of nonperformance. Hours of service can be based on actual hours or one of the two available equivalency methods. Under the first equivalency method, eight hours of service is credited for each day for which the employee would be required to be credited with at least one hour of service. Under the second, 40 hours of service is credited for each week for which the employee would be required to be credited with at least one hour of service. Different methods of determining hours of service can be applied to different classes of employees (e.g., hourly and salaried) if the classifications are reasonable and consistently applied.

Calculating Average Annual Wages

The amount of average annual wages is calculated by dividing the total wages paid by the employer during the employer’s tax year to employees who perform services for the employer during the tax year by the number of the employer’s FTEs for the year. Round the result down to the nearest \$1,000.

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Wages for this purpose means wages as defined for purposes of the Federal Insurance Contributions Act (FICA) (without regard to the wage-base limitation). As with the calculation of FTEs, generally all employees of the controlled group or affiliated service group are taken into account for purposes of calculating average annual wages, with the exception of seasonal workers who work fewer than 120 days during the tax year and certain owners (sole proprietors, partners in a partnership, shareholders owning more than 2 percent of an S corporation, and any owner who is a more than 5 percent owner of any other types of business entities) and their family members.

Qualifying Arrangement

A qualifying arrangement is an arrangement under which the employer pays premiums for each employee enrolled in health benefits coverage offered by the employer in an amount equal to a uniform percentage that is not less than 50 percent of the premium cost of the coverage. Certain transition rules apply for years beginning in 2010 for the uniformity requirements.

Calculating the Tax Credit

Maximum Tax Credit

The maximum tax credit is equal to 35 percent of a small business' premium costs (25 percent for tax-exempt employers). On January 1, 2014, this rate increases to 50 percent (35 percent for tax-exempt employers). The maximum credit is available only to those employers with 10 or fewer FTEs receiving annual average wages of \$25,000 or less. The tax credit phases out gradually for entities with average wages between \$25,000 and \$50,000 and for entities with between 10 and 25 FTEs.

Premium Costs

The premiums paid by the employer for health insurance coverage are included in the premium cost for purposes of

calculating the tax credit if the premiums are paid under a qualifying arrangement. For years prior to 2014, health insurance coverage for this purpose includes:

- Benefits consisting of medical care under any hospital or medical service policy or certificate, hospital or medical service plan contract, or HMO contract offered by a health insurance issuer;
- Limited scope dental or vision
- Long-term care, nursing home care, home health care, community-based care, or any combination thereof;
- Coverage only for a specified disease or illness;
- Hospital indemnity or other fixed indemnity insurance; and
- Medicare supplemental health insurance, certain other supplemental coverage, and similar supplemental coverage provided to supplement coverage under a group health plan. Further, to the extent that the employer pays premiums on behalf of seasonal employees, they may be counted in determining the amount of the employer's credit.

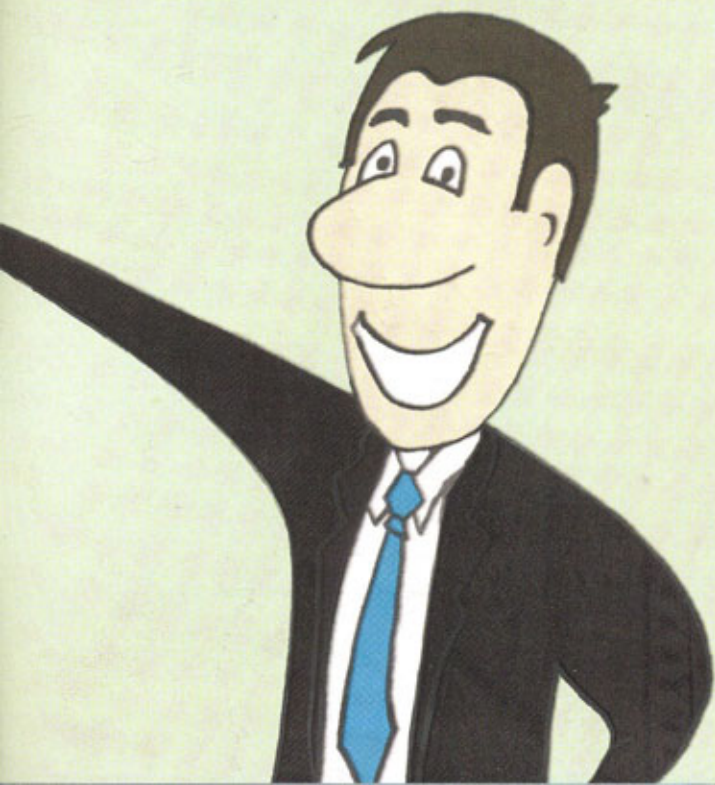
If an employer offers more than one type of coverage, such as a major medical plan and a separate limited scope dental or vision plan, the employer must separately satisfy the requirements for a qualifying arrangement with respect to each type of coverage the employer offers. An employer cannot aggregate different plans for purposes of meeting the qualifying arrangement requirement.

The following costs are not taken into account as "premium costs:"

- Premiums paid on behalf of certain owners and their family members;
- Contributions to health reimbursement arrangements, health flexible spending arrangements, and health savings accounts;
- Premiums paid pursuant to a salary reduction arrangement under a Section 125 cafeteria plan; and
- Premiums for health insurance coverage paid by a leasing organization for a leased employee, as described in 414(n) of the Internal Revenue Code, which generally does not include the worksite employees of PEOs.

Cap on Premium Costs

The amount of an employer's premium costs for purposes of the tax credit cannot exceed the premium payments the employer would have made under the same arrangement if the average premium rates for the small group market in the state in which the employer offers coverage were substituted for the actual premium. The IRS provided the following examples in IRS Notice 2010-44: If an employer pays 80 percent of the premiums for coverage provided to the employees and the employees pay the other 20 percent, the premium amount taken into account for purposes of the credit is the lesser of 80 percent of the total actual premiums paid or 80 percent of the premiums that would have been paid for the coverage if the average premium for the small group market in the state was substituted for the actual premium. The average premium for the small group market provides an overall cap for all health insurance coverage provided by a qualified employer.



Tax Credit Phase Out

If the number of FTEs exceeds 10 or if the average annual wages exceed \$25,000, the amount of the tax credit is reduced.

To determine the amount of the reductions, the IRS provided the following formulas in IRS Notice 2010-44: If the number of FTEs exceeds 10, the reduction is determined by multiplying the otherwise applicable credit amount by a fraction, the numerator of which is the number of FTEs in excess of 10 and the denominator of which is 15. If average annual wages exceed \$25,000, the reduction is determined by multiplying the otherwise applicable credit amount by a fraction, the numerator of which is the amount by which average annual wages exceed \$25,000 and the denominator of which is \$25,000. 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.

If an employer has more than 10 FTEs and average annual wages exceeding \$25,000, the reduction in the credit amount is the sum of the two reductions. This sum may result in a tax credit of zero for some employers even if they have fewer than 25 FTEs and average annual wages of less than \$50,000.

Affect of State Credit or Subsidy

Some states offer tax credit or premium subsidy programs to certain small employers that provide health insurance to their employees. State tax credits and payments to an employer gener-

ally do not reduce an employer's otherwise applicable tax credit. Further, premium payments made directly by states are generally considered employer payments for purposes of a qualifying arrangement. However, the amount of the tax credit may *not* exceed the amount of the employer's net premium payments. Any state tax credit for an employer or a state subsidy paid directly to an employer is subtracted from the employer's actual premium payments to determine the net premium payments. If a state makes payments directly to an insurance company (or another entity licensed under state law to engage in the business of insurance), the employer's net premium payments are the employer's actual premium payments.

As mentioned above, this is an overview and does not address all of the various requirements or situations. More detailed guidance and examples can be found in IRS Notice 2010-44 (www.irs.gov/pub/irs-drop/n-10-44.pdf) and IRS Notice 2010-82 (www.irs.gov/pub/irs-drop/n-10-82.pdf). ●

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