

Small Business Health Care Tax Credit

This information is only intended as a high-level guide and is not to be relied upon as actuarial, tax or legal advice. You should seek advice from an accountant and attorney to determine how the credit may affect your specific situation.

Overview

How does the small business tax credit work?

The Patient Protection and Affordable Care Act provides for tax credits to certain small businesses (no more than 25 full-time equivalent employees) that offer health benefits. The tax credits vary depending upon the tax status of the organization and the aggregate amount of employer contributions toward health benefits.

What is the effective date of the credit?

The credit begins for tax years beginning 1/1/2010.

In 2014 when the credit goes to 50 percent of premiums paid (35 percent for tax exempt eligible small employers), will the credit be available ONLY in the Small Business Health Options Program (SHOP) Exchange or outside of the SHOP Exchange as well?

For tax years beginning in 2014 the credit is only available to small businesses that purchase health coverage through a SHOP.

Does “Grandfather Status” affect the credit?

Our understanding of the grandfathering provision is that small employers can take advantage of the tax credit whether they have a grandfathered plan design or not. When Exchanges (also called Health Insurance Marketplace) are implemented in 2014, small employers with a grandfathered plan will not be eligible for the tax credit unless they are willing to purchase a qualified benefit plan through the SHOP.

Eligibility

Are management carve out policies eligible for the tax credit?

The IRS has not issued any guidance specific to this question. Note: the wage phase out applies and higher salaried employees could reduce the credit.

Are owners and family members always excluded from both the eligible employees and the estimated annual wages or is it optional?

If a family member is an excluded employee, then family members presumably aren't counted for purposes of determining whether the “average annual wages of the employer” exceed certain inflation-adjusted dollar limitations for purposes of the definition of an eligible small employer.

Do employer contributions to dependent premiums count toward the credit?

Yes, the employer paid portion of coverage greater than single (dependent, family) is used in computing the tax credit. One distinction to make is that first the employer must determine if it meets eligibility. The part of the eligibility requirement that the employer pay at least 50 percent of the premium for an employee applies to the premium for single (employee only) coverage. Therefore, if the employee is receiving single coverage, the employer satisfies the 50 percent requirement with respect to the employee if it pays at least 50 percent of the premium for that coverage. If the employee is receiving coverage that is more expensive than single coverage (such as family or self-plus-one coverage), the employer satisfies the

50 percent requirement with respect to the employee if the employer pays an amount that is no less than 50 percent of the premium for single coverage (even if it is less than 50 percent of the premium for the coverage the employee is actually receiving). The amount of employer paid premiums including dependent premiums is included in the computation of the credit after eligibility is met.

NOTE: The transitional relief for tax years beginning in 2010 that applies with respect to the requirements for a qualifying arrangement are: a) An employer that pays at least 50 percent of the premium for each employee enrolled in coverage offered to employees by the employer will not fail to maintain a qualifying arrangement merely because the employer does not pay a uniform percentage of the premium for such employee and b) The requirement that the employer pay at least 50 percent of the premium for an employee applies to the premium for single (employee only) coverage for the employee.

Does the employer contribution level make a difference in the credit amount? What if an employer contributes 75 percent?

If the employer contributes more for premiums on behalf of the employee, then the credit amount will be greater (all other things being equal and the employer meets the qualifications).

Does the tax credit apply to both employer paid and voluntary products?

Small employers can only take advantage of the tax credit if they pay at least 50 percent of the health, dental and/or vision premium. This is not likely to occur with a voluntary product.

How is common ownership viewed in terms of being able to access this credit?

There are aggregation rules under IRC Section 45R(e)(5) that state all employers are treated as a single employer if they are commonly controlled. The following are subject to aggregation rules: controlled groups of corporations, commonly controlled partnerships or sole proprietorships, and affiliated service groups. In addition, the IRS is permitted to prescribe aggregation rules in regulations to prevent the avoidance of certain employee benefit rules.

If an employer has fewer than 25 full-time equivalent employees (FTEs) but employees are leased from a large professional employer organization (PEO), is the employer disqualified for the tax credit?

Where the leased employee performed services for the employer for at least one year under the primary direction and control of the employer, the leased employee is counted in computing the employer's FTEs and average annual wages. This means that leased employees could, in some circumstances, disqualify an employer for purposes of the tax credit.

Are otherwise eligible small employers who participate through a multi-employer program eligible in their own right to receive the tax credit?

For the purposes of the tax credit, employer contributions to a fully insured multi-employer plan that are used to pay premiums for health insurance coverage for employees covered by the multi-employer plan are treated as payment of health insurance premiums by the employer. Therefore, so as long as the employer otherwise qualified for the credit, the plan (rather than the employer) may pay the premiums directly and the employer will still be eligible for the credit. The qualified employer will also be considered to be paying a uniform percentage of the premium for each employee if 100 percent of the cost of coverage for all employees and employers participating in the plan is paid through employer nonelective contributions. Further, it does not matter how the multiemployer program describes its ERISA status, whether at the multi-employer plan level or at the individual employer level.

If the employees are multi-state, how is the credit affected?

Employers with employees in multiple states must apply the average premium for the small group market in the states separately for each employee, using the average state premium for the state in which the employee works.

Does an organization's legal structure (S-Corp, C-Corp, Sole Proprietor, etc.) affect eligibility for this credit?

The form of the organization does not specifically affect eligibility for the credit. In most cases the owner/shareholders of virtually any type of small business organization and their family members will not be counted as eligible persons for the calculation of the credit.

Partners in a business and certain owners are not counted as employees. Specifically, sole proprietors, partners in a partnership, shareholders owning more than 2 percent of an S corporation, shareholders owning more than 5 percent of outstanding stock or possessing more than 5 percent of total combined voting power of all stock of a corporation that is not an S corporation, and a person who owns more than 5 percent of the capital or profits interest in any other business that is not a corporation are not counted as employees for purposes of the credit.

Family members of these owners and partners are also not counted as employees. For purposes of this credit, a family member is defined as a child (or descendant of a child); a sibling or step-sibling; a parent (or ancestor of a parent); a step-parent; a niece or nephew; an aunt or uncle; or a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law or sister-in-law. Finally, any other member of the household of these owners and partners who qualifies as a dependent under section 152(d)(2)(H) is not counted as an employee.

Accordingly, the wages and hours of these business owners and partners, and of their family members and dependent members of their household, are disregarded in determining FTEs and average annual wages, and the premiums paid on their behalf are not counted in determining the tax credit.

Is the small business health care tax credit only available if an employer provides medical insurance? Or can employer groups be eligible for the credit if they provide stand-alone dental and/or vision insurance?

In general, after 2014, only premiums paid by the employer for employees enrolled in a Qualified Health Plan (QHP) offered through a SHOP will be counted when calculating the credit. Recent guidance on the Exchange standards has indicated that stand-alone dental plans will generally be considered QHPs. Prior to 2014, according to IRS Notice 2010-44, health insurance coverage for purposes of the credit includes limited scope dental or vision. Additionally the IRS Notice states that different types of health insurance plans are not aggregated for purposes of meeting the qualifying arrangement requirement. So, for example, if an employer offers a major medical insurance plan and a stand-alone vision plan, the employer must separately satisfy the requirements for a qualifying arrangement with respect to each type of coverage.

What are the parameters of “family” members for the purposes of excluding wages?

If family members are excluded employees, then family members presumably aren't counted for purposes of determining whether the “average annual wages of the employer” exceed certain inflation-adjusted dollar limitations for purposes of the definition of an eligible small employer. A “family member” is defined as a child, descendant of a child, brother, sister, stepbrother, stepsister, stepfather, stepmother, niece, nephew, uncle, aunt, son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, sister-in-law, a spouse, or any other relative that has the same principal place of abode as the taxpayer and is a member of the taxpayer's household (this includes non-family members who are members of the taxpayer's household and qualify as a dependent on the individual income tax return of the excluded individual).

What does the term “full time equivalent” employee mean?

The full time equivalent total is arrived at by counting the total number of hours worked, for which wages were paid during the tax year, divided by 2,080. This is rounded to the next lowest whole number. If an employee works in excess of 2,080 hours during the taxable year, the excess is not counted. This figure does not include the hours worked by seasonal employees unless the seasonal employee worked for an employer more than 120 days during the tax year.

Which employees of the employer are counted?

Generally, the employer should count all employees during the year for which the credit is being claimed when computing both the full time employee equivalents and the annual average wages under Section 45R. This includes former employees who terminated employment during the year for which the credit is being claimed, employees covered under a collective bargaining agreement and employees who do not enroll in the employer's health insurance plan (whether or not they are covered under another health insurance plan).

What happens if the group has a base plan and a buy-up plan? Are they required to pay at least 50 percent of both the base and the buy-up plan to qualify?

For plan years beginning on or after Jan. 1, 2014, employers may satisfy the requirement in one of two ways. First, they can meet the uniform percentage requirement on a plan by plan basis, so they would be eligible if they provide no less than 50 percent of premiums for the base plan and 50 percent for the buy-up plan. Second, they may designate a reference plan, and then determine a level of employer contributions that would meet the uniform

percentage requirement for the reference plan. The employee can then apply the employer contributions to either the reference plan, or another qualified health plan offered by the employer.

Which small business owners are eligible for the tax credit?

Employers with no more than 25 “full time equivalent employees” whose average annual wages do not exceed \$50,000 are eligible.

Are contributions to a self-funded plan generally counted as qualified premium payments for the purposes of determining the credit?

Except in the case of church plans previously noted, contributions to a self-funded health benefit program are not considered to be qualifying premiums since a self-funded plan is not a qualifying arrangement. The statute contemplates that only insurance premiums paid to a licensed insurance carrier or licensed health plan will be counted.

Do employer contributions to HRAs, HSAs and FSAs count as qualified premium payments?

Any payment that can be characterized as a self-funded contribution is not considered to be a qualifying arrangement and may not be counted as a qualified contribution to the plan. Health Reimbursement Accounts, Health Savings Accounts and health Flexible Spending Accounts are considered to be self-funded plans for the purposes of the credit calculation.

Are there any restrictions on what type of tax-exempt organization may take the credit?

Tax-exempt organizations must be both described in Code Section 501(c) and be exempt from taxation under Code Section 501(a). However, a Code Section 521 farmers’ cooperative that is subject to tax under Code Section 1381 is eligible.

Are religious organizations that provide coverage through a self-funded church plan eligible for the credit?

Since church-sponsored self-funded welfare benefit plans are subject to state insurance law enforcement to the same degree as if the plans were an insurer licensed by the state under the Church Plan Parity and Entanglement Prevention Act of 1999, contributions to such plans by churches will be considered to be qualifying premium for the purpose of the credit. This is the only self-funded contribution that will be considered to be qualifying premium under the small business tax credit.

What happens if the employer’s employee numbers fluctuate throughout the year?

The IRS has not issued any guidance regarding at what point during the tax year eligibility has to be met.

A group has fewer than 25 FTEs but employs a larger number of union employees. Do the union employees count toward the group’s total FTEs?

Yes. The IRS has determined that for purposes of determining the employer’s FTEs and average annual FTE wages, employees include employees covered under a collective bargaining agreement, as well as employees who terminated during the year for which the credit is claimed and employees who do not enroll in a QHP offered by the employer.

Do the wages of 1099 employees figure into the total wages?

No. The hours and wages of independent contractors are not counted when determining an employer’s eligibility for the credit.

Federal Program vs. State Programs

How does the federal tax credit impact any state tax credit program that may be in effect? Can an employer participate in both or would that be considered “double dipping”?

There is no reduction to the federal credit if a taxpayer receives a state credit; therefore, the employer can take advantage of both. Note that in no case may the tax credit exceed the net premium amount paid by the employer.

Other

If the credit exceeds taxes paid in a tax year what happens?

Since the credit is nonrefundable for non-tax-exempt entities (cannot exceed the tax liability for a tax year), the excess credit can be carried back 1 year or carried forward 20 years. Since 2010 is the first year of the credit, any excess credit in 2010 cannot be carried back to 2009.

Is it legal for a larger group (with more than 25 employees) to reorganize into a smaller group with fewer than 25 employees in order to qualify for the small business health care tax credit? Would they be able to take advantage of the tax credit?

The IRS has not addressed this issue but would likely apply a “bona fides” test to any such division similar to tests that are being imposed on business organization changes under other aspects of the Reform law.

If a group is participating in a state level association where the plan is at the association level (and therefore not eligible for the credit) can the group break away from the state association and therefore, purchase their benefits outside of the state association as a stand-alone small employer?

Yes. This is not a structural change to the employer and the employer should be able to offer its own qualified health plan.

Is the credit better than the normal deduction the employer may be entitled to? Could an employer take advantage of both?

Generally small employers who are paying tax in the lower tax brackets will obtain a greater benefit by taking the credit than the deduction. The employer should discuss its specific tax situation with its tax advisor. The statute clearly states that any deductible amount for health insurance premiums must be reduced by the amount of the credit, so the employer may not take advantage of both.

What is the difference between a tax deduction and a tax credit? Does one affect the other?

The health care tax credit will provide a greater tax benefit/tax savings than a tax deduction. A tax deduction provides for a deduction of premium expense in determining taxable income. A tax credit is a reduction of the tax liability (after application of the tax rate on taxable income). For example, if an employer has 10 FTEs with average annual wages of \$25,000 and pays \$75,000 of employee health care premiums the tax credit = \$26,250. The tax deduction the employer would take if they didn't take the credit would be \$75,000 - apply the tax deduction of \$75,000 by the graduated tax rate and if the employer is in the \$335,000 to \$10M tax bracket the tax deduction would result in \$25,500 reduction in tax liability. You can see that the tax credit generates a higher tax savings than the deduction.

How will 501(c)(3) employers claim their credit?

An employer that is described in section 501(c) and exempt from tax under section 501(a) claims the credit by filing the Form 990-T, Exempt Organization Business Income Tax Return, with an attached Form 8941 showing the calculation of the claimed credit. Filing Form 990-T with an attached Form 8941 is required for a tax-exempt eligible small employer to claim the credit, even if it is not otherwise required to file Form 990-T.

Can the credit reduce the amount of employment tax payments for the employer or only the income tax for the employer?

According to the IRS website a tax-exempt employer may not reduce employment tax payments during the year in anticipation of the credit (irs.gov as of 7/8/10). For-profit employers may reflect the credit in determining estimated income tax payments for a year.

How does the credit get applied to shareholders of an S-corp employer?

The S-corporation would reflect the credit on the federal return and the credit would flow through to the S-corporation shareholders to be claimed on the shareholders' tax return.

How is the credit applied differently for for-profit groups versus not-for-profit groups?

For tax-exempt employers the credit is refundable for the lesser of: a) the amount of credit or b) the amount of the payroll taxes (payroll taxes are income and Medicare tax the employer is required to withhold from employees' wages and the employer share of Medicare tax on employees' wages for the year) of the employer during the calendar year in which the tax year begins. The credit for for-profit employers is applied against income tax.

Do sales commissions count toward the total annual employee wages?

Generally wages include sales commissions.

Can the health care credit be used to offset alternative minimum tax (AMT)?

Yes, the health care credit is a "specified credit" and can be used against the AMT.

