PUBLICATION

Spotlight on Health Care Reform: IRS Guidance on PPACA's Small Business Tax Credit

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Under the Patient Protection and Affordable Care Act of 2010, a tax credit is available to qualified small employers which meet certain criteria relating to the provision of health insurance for their employees. Both taxable and tax-exempt employers may qualify.

New Internal Revenue Code Section 45R provides a tax credit that is designed to encourage both taxable employers and tax exempt employers either to offer coverage for the first time or maintain existing coverage. The credit is available from 2010 through 2016 and has two Phases. Phase I covers up to 35% (25% for tax-exempt employers) of the employer's contribution to health insurance premiums through 2013, as a lead-in to the establishment of the health insurance exchanges beginning in 2014. Smaller employers with lower average wages may qualify for the higher credit rates. Phase II, with credits as high as 50% of employer contributions, begins in tax year 2014 and lasts for the first two years in which the employer offers coverage through a state Health Insurance Exchange. Current IRS guidance only addresses Phase I.

The size of the employer is based on controlled group and affiliated service group rules which apply for other purposes, so that certain significantly related entities are treated as a single employer for this purpose.

On May 17, the IRS released comprehensive guidance that addresses a number of important issues regarding the Phase I credit. That guidance provides steps for determining eligibility for the credit, explains how to calculate the credit, and includes information on transition relief for taxable years beginning in 2010 with respect to certain requirements.

Steps for Determining Eligibility

The IRS guidance outlines five steps for an employer to use to determine whether it is eligible for the tax credit:

1. Determine the employees who are taken into account for purposes of the credit.
2. Determine the number of hours of service credited to those employees.
3. Calculate the number of the employer's full-time equivalent employees (FTEs).
4. Determine the average annual wages paid per FTE.
5. Determine the premiums paid by the employer that are taken into account for purposes of the credit. Specifically, the premiums must be paid by a small employer under a qualifying arrangement and must be paid for health insurance that meets the requirements of Section 45R.

Three Qualifications for Employers

In order for a small employer to qualify for the credit, that employer must 1) have fewer than 25 full-time equivalent employees (FTEs) for the taxable year; 2) have average annual wages of less than $50,000 per full-time equivalent employee; and 3) maintain a "qualifying arrangement" as discussed below.

It is important to note that the IRS guidance explicitly states that even though Section 45R says "no more than" 25 full-time equivalent employees, because of the language of the tax credit portion of the statute the Service

will not interpret employers with exactly 25 FTEs (or, for that matter, average pay of exactly $50,000) as being eligible for the credit.

Important Exclusions

In general, employees who perform services for an employer during a taxable year are taken into account in determining the number of FTEs, average wages, and premiums paid. However, the Service's guidance excludes a number of classes of individuals from this calculation.

Specifically, in determining hours and wages, sole proprietors, partners in a partnership, shareholders owning more than two percent of an S corporation and any owners of more than five percent of other businesses are disregarded, as are their family members as defined in the guidance. For example, these individuals are not taken into account in determining the number of FTEs or premiums paid. Similarly, seasonal workers are disregarded for these purposes unless they work for the employer more than 120 days during the taxable year, though premiums paid for seasonal workers may still be taken into account.

Flexibility in Calculating Hours Worked

The guidance provides three methods for calculating the total number of hours an employee has worked in a year. The IRS and Treasury recognized that employers use different accounting systems to keep track of the service of their employees, so they allowed for flexibility in determining which system to use.

The three methods from which an employer can choose are as follows:

6. Determine actual hours of service from records of hours worked, and hours for which payment is made or due (such as for paid sick days, vacations and holidays) up to 160 hours per continuous absence;
7. Use a "days-worked equivalency" to credit 8 hours of service for each day for which he or she would be required to be paid anything; or
8. Use a "weeks-worked equivalency" to credit 40 hours of service for each week for which he or she would be required to be paid anything.

The average wage of the includable group is determined by dividing the total FICA wages of all employees taken into account (for the hours taken into account) by the number of FTEs, rounded down to the nearest $1,000.

Premiums paid are taken into account only to the extent of the portion which the employer ultimately pays, disregarding any premium paid by the employee or others on either an after-tax or pre-tax basis. For 2010, the employer is allowed to count all employer-paid premiums, even for the period in 2010 before the passage of PPACA. Only premiums paid for a qualifying arrangement are counted. A qualifying arrangement generally includes only an arrangement for which the employer pays a uniform percentage of at least 50% of the premium cost of health coverage for each covered employee. However, for 2010 only, an employer which pays at least 50% of the premium for employee-only (single) coverage will qualify, even if the percentage is not uniform for all employees. Until 2014 health insurance means any medically-related coverage as described in the Service's guidance. The 50% requirement must be satisfied for each different type of medical care to claim the credit for that different coverage. The employer-paid premium which can be taken into account for the credit is limited to the average premium for the small group market in the state.

Calculating the Credit

For 2010 through 2013, the maximum credit is 35% (25% for tax-exempt entities) of the premium payments, determined as described above. Further limits apply to the credit for tax-exempt entities, and the IRS will need to develop special procedures in such circumstances to claim the credit.

For small employers, if the number of FTEs exceeds 10 or if the average wage exceeds $25,000, then the available credit is reduced, but not below zero. Two reduction factors are used to calculate the amount of the credit reduction. For greater than 10 FTEs, the credit is multiplied by a fraction, the numerator of which is the number of FTEs greater than 10, and the denominator of which is 15. For average wages above $25,000, the reduction factor for the available credit is average wages above $25,000 divided by $25,000. The SUM of BOTH reductions is the amount by which the available credit is reduced.

The Section 45R credit is not generally reduced by any state tax credits or payments for providing coverage. In fact, payments made by a state on behalf of an employer to provide coverage are still treated as an employer contribution for Section 45R credit purposes. However, after all calculations are completed, the credit to the employer may not exceed the employer's net premium payment (net of the state payments).

The credit is claimed on the small employer's federal income tax return as a general business tax, and reduces the tax otherwise due. A small business need not wait until it files the federal income tax return for the following year, but rather it can claim a credit against estimated tax deposits. In addition, unused credit amounts can be carried back one year (but unfortunately not for any year before 2010) and forward for 20 years. Again, tax-exempt employers will receive a refundable credit amount by some other method to be developed, limited to the tax-exempt entity's total income tax withholding and Medicare tax liability for the year.

Credits may be applied against estimated tax payments which are currently due, and to offset alternative minimum tax (AMT) liabilities. The credit may not be applied against employment taxes (income tax withholding, Social Security taxes or Medicare taxes). The credit taken then reduces the employer's deduction for healthcare premiums paid.

Issues Going Forward

The IRS guidance is quite comprehensive in some respects, providing detailed information as to how to calculate the credit. But some issues need resolution. For example, the procedures for tax-exempt employers will need to be developed and Phase II (post-2013) guidance will be required.

Examples

The IRS has provided the following examples.

Example 1: An auto repair shop with 10 employees gets a $24,500 credit for 2010:

- *Employees*: 10
- *Wages*: $250,000 total, or $25,000 per worker
- *Employee Health Care Costs*: $70,000

2010 Tax Credit: $24,500 (35% credit)

2014 Tax Credit: $35,000 (50% credit)

Example 2: Restaurant with 40 part-time employees gets a $28,000 credit for 2010:

- *Employees*: 40 half-time employees (the equivalent of 20 full-time workers)
- *Wages*: $500,000 total, or $25,000 per full-time equivalent worker
- *Employee Health Care Costs*: $240,000

2010 Tax Credit: $28,000 (35% credit with phase-out)

2014 Tax Credit: $40,000 (50% credit with phase-out)

Should you have questions or wish to discuss this tax credit, contact any attorney in our Tax or Health Departments.