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Subject: “**STRATEGIC INSIGHTS NEWSLETTER – *Special Small Business Edition***”

The New Health Care Premium Tax Credit For Small Business

While the jury is still out on the overall impact of the recently enacted Affordable Care Act (the “ACA”), the ACA does contain a significant benefit for many small businesses in the form of a tax credit for their employee health insurance premiums. This credit is limited to “eligible small employers” or “ESEs” which are businesses (1) with fewer than 25 full-time employees that (2) pay average annual wages of less than \$50,000. A 35% credit is available for eligible health insurance premiums paid in taxable years beginning before December 31, 2013, with an increase to 50% for taxable years beginning on or after January 1, 2014 if the premiums are paid to a qualified health plan offered by the ESE through a state-based insurance exchange.

IRS Guidance

On May 17, 2010, the IRS issued Notice 2010-44 (the “Notice”), its first official guidance interpreting Section 45R of the Internal Revenue Code, which implements the new health insurance premium tax credit. The Notice only applies to taxable years starting prior to 2014, and addresses the following four issues: (1) which employers are eligible for the credit; (2) how to calculate the credit; (3) how to claim the credit; and (4) transitional relief for taxable years beginning in 2010.

Determining Who is an Eligible Small Employer. The Notice explains how to determine whether an employer (i) has fewer than 25 full-time equivalent employees (FTEs) for the taxable year; (ii) pays average annual wages of less than \$50,000 per FTE; and (iii) maintains a “qualifying arrangement.” A “qualifying arrangement” is an arrangement under which the employer pays not less than 50 percent of the premium cost of covering each employee enrolled in the ESE’s health insurance plan. The foregoing determinations are made in the following manner:

- Generally, all employees of the ESE are taken into account, except seasonal workers who work 120 days or less during the taxable year, partners, business owners and family members of the partners and business owners. The number of hours worked by these employees is determined in much the same fashion as hours are credited for retirement plan purposes. The number of FTEs is then calculated by dividing the total hours worked by 2080.
- To determine the average annual wages paid by the ESE for a taxable year, the total wages paid to the employees counted in Step 1 are divided by the number of FTEs for that year. Wages means wages for FICA purposes, disregarding the wage base limitation.

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- To determine whether the ESE's health insurance premiums were paid under a "qualifying arrangement" the premiums must (1) be paid by the ESE (*i.e.*, they can't be charged to the employee under a salary reduction arrangement such as a cafeteria plan); and (2) pay for health insurance coverage, which means for years prior to 2014 coverage under a medical insurance plan (including dental and vision plans), long-term care plan, nursing home care plan, home health care plan, community-based care plan, specified disease or illness insurance plan, hospital indemnity insurance plan, Medicare supplemental health insurance plan and other supplemental insurance plans. Where an ESE maintains more than one health insurance plan the ESE must pay at least 50% of the premium costs for each plan. The amount of the premiums that the ESE may take into account in calculating the credit is capped at the average premium for comparable coverage for the small group market in the state in which the ESE is located.

Calculating the Allowable Credit. The Notice explains the two adjustments that are required to be made to the basic credit equal to 35% of the ESE's credit-eligible premium expenses. These adjustments are as follows:

- The amount of the tax credit must be phased out for any ESE with more than 10 FTEs or that paid average annual wages of more than \$25,000, and is eliminated if the ESE has 25 or more FTEs or pays average annual wages of \$50,000 or more. Separate reductions are required if the FTE has between 10 and 50 FTEs or pays its FTEs average annual wages of more than \$25,000 but less than \$50,000.
- In calculating the credit the amount of an ESE's eligible health insurance premiums must be reduced dollar for dollar for any state tax credits or subsidies that the ESE receives (*i.e.*, the credit is based on the ESE's net premium payments after reduction by any state tax credits or subsidies).

Claiming the Credit. The Notice explains how an ESE claims the credit on its annual income tax return as an offset to its actual tax liability for the year. Since the credit is a general business credit, any unused credit amount can be carried back one year and carried forward 20 years (except that any unused credit from 2010 can only be carried forward).

2010 Transition Relief. As noted above, ESEs must maintain a "qualifying arrangement" to qualify for the credit, which means that the ESE must pay a uniform percentage of not less than 50 percent of the premium cost of providing health insurance coverage to its employees. For taxable years beginning in 2010 only, this "uniformity requirement" will be deemed satisfied if the ESE pays an amount equal to at least 50% of the premium for single coverage for each employee enrolled in the program. Thus, for 2010 only, an ESE can pay a lesser percentage for employees enrolled in family coverage as long as the employer pays an amount equal to at least 50 percent of the single coverage premium for those employees.

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