

## Legislative Alert

# Small business health care tax credit



Small businesses are the beneficiaries of one of the first-to-apply provisions of federal healthcare reform. Under the Patient Protection and Affordable Care Act, small businesses that provide health care coverage to their employees can receive a tax credit, effective for tax years beginning in 2010 and later. The Internal Revenue Service (IRS) recently issued guidance on this tax credit, which is summarized below and is available in detail at the following link: <http://www.irs.gov/newsroom/article/0,,id=220839,00.html>

## Eligible employers

Small businesses are eligible to receive the tax credit if they meet all three of the following requirements:

- The employer has fewer than 25 full-time equivalent employees (FTEs) for the tax year. The number of FTEs is determined by adding up all of the hours for which the employer pays wages to employees during the year (but not more than 2,080 hours per year for any employee), and dividing those total hours by 2,080. The result is rounded down to the next lower whole number. For example, if the employer has 100 part-time employees, and they are paid for a total of 49,000 hours of work, then the employer has

23 FTEs (i.e., 49,000 divided by 2,080, rounded down), which means that the employer satisfies this requirement even though it has more than 25 employees.

- The average annual wages (AAW) per FTE is less than \$50,000. The AAW is determined by adding up all of the wages (defined as FICA wages) paid by the employer to employees during the taxable year, and dividing the total wages by the number of FTEs for the year. The result is rounded down to the next lower \$1,000. For example, if the total FICA wages for 2010 are \$1 million, and the employer has 23 FTEs, then the AAW is \$43,000 (i.e., \$1 million divided by 23, or \$43,478.26, rounded down), which means that the employer satisfies this requirement.
- The employer must pay for all or a portion of employees' health care premiums under a "qualifying arrangement." A qualifying arrangement is one in which the employer pays premiums for each employee enrolled in the health plan in an amount equal to a uniform percentage (but not less than 50 percent) of the premium cost of the coverage (see below for special rules that apply in 2010). The 50 percent requirement applies to the premium for single or employee-only coverage, even if the employee is enrolled in family coverage. Employee pre-tax contributions made through a cafeteria plan are not treated as employer contributions for purposes of this requirement. For example, if the employer pays 100 percent of the cost of employee-only coverage, and 0 percent of the cost of dependent coverage, then the "qualifying arrangement" requirement is satisfied.

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In evaluating these requirements, seasonal workers and their wages are not counted unless they work more than 120 days during the taxable year. Likewise, owners (including two percent owners of an S corporation, and five percent owners of other businesses), their family members, and wages are not counted.

It is important to note that the above requirements are evaluated on a controlled-group basis, which means that all employers that are members of the same controlled group of companies are treated as a single employer. For example, if a small business satisfies all three of the above requirements, but it is wholly owned by General Electric, then that business is not eligible for the tax credit.

## Calculating the tax credit

For tax years 2010 to 2013, the maximum tax credit is 35 percent of the employer premium expenses under the qualifying arrangement. For qualified employers that are tax-exempt entities, the maximum tax credit is 25 percent of the employer premium expenses. Premiums paid in 2010 prior to enactment of health care reform legislation may be counted for purposes of the 2010 tax year credit.

The tax credit is subject to two important dollar limitations. First, if the premium for the employer's group health plan exceeds the average premium for the small group market in the state where the employer is located, then the employer's tax credit is based on the average premium for the small group market (and not the premium for the more expensive plan maintained by the employer). For example, if an employer pays 80 percent of the \$500-per-month premium for single coverage under its health plan, and the average premium for single coverage in the small group market in that state is \$400 per month, then the tax credit is based on the employer's payment of \$320 per month (80 percent of \$400). The U.S. Department of Health and Human Services is responsible for determining the average premium for each state's small group market, and the IRS is responsible for making this information available to small employers in the near future.

Second, the tax credit is reduced to the extent that the employer has more than 10 FTEs, and to the extent that AAW exceed \$25,000. In other words, the tax credit will decrease as the number of employees and payroll increases.

- If the number of FTEs exceeds 10, the amount of the tax credit reduction is determined by taking the otherwise applicable tax credit amount, and multiplying it by a

fraction. The numerator of the fraction is the number of FTEs in excess of 10, and the denominator is 15. For example, if the tax credit (prior to reduction) is \$30,000, and the employer has 15 FTEs, then the tax credit is reduced by \$10,000 (i.e., 15 FTEs minus 10 FTEs, divided by 15 FTEs, and multiplied by \$30,000). The net tax credit for the employer is \$20,000 (i.e., \$30,000 minus \$10,000).

- If AAW exceed \$25,000, the amount of the tax credit reduction is determined by taking the otherwise applicable tax credit, and multiplying it by a fraction. The numerator of the fraction is the amount by which AAW exceed \$25,000, and the denominator of the fraction is \$25,000. For example, if the tax credit (prior to reduction) is \$40,000, and AAW are \$35,000, then the tax credit is reduced by \$16,000 (i.e., \$35,000 minus \$25,000, divided by \$25,000, and multiplied by \$40,000). The net tax credit for the employer is \$24,000 (i.e., \$40,000 minus \$16,000).

Both the FTE and AAW reductions may apply to a single employer. For example, suppose that an eligible employer has 12 FTEs and AAW of \$30,000. The employer pays \$96,000 in health care premiums for those employees and otherwise meets the requirements for the tax credit. The net tax credit is calculated as follows:

Initial amount of tax credit determined before any reduction	$35\% \times \$96,000 = \$33,600$
Reduction in tax credit for FTEs in excess of 10	$(12 - 10) \div 15 \times \$33,600 = \$4,480$
Credit reduction for AAW in excess of \$25,000	$(\$30,000 - \$25,000) \div \$25,000 \times \$33,600 = \$6,720$
Total reduction in tax credit	$\$4,480 + \$6,720 = \$11,200$
Net tax credit	$\$33,600 - \$11,200 = \$22,400$

## Claiming the tax credit

Employers claim the tax credit on their annual income tax returns. For-profit employers that do not have taxable income may not claim the tax credit because they have no income tax to offset. Employers that receive the tax credit will also lose the tax deduction for the amount of their employer contributions for employees' healthcare coverage, to the extent that they receive the tax credit.

Tax-exempt entities that meet the three requirements described above for being an eligible employer can receive the tax credit, even though they do not pay income taxes. The IRS has promised to issue guidance in the near future on how they can claim the tax credit.

## Special rules for 2010

The above rules were issued after the beginning of the 2010 tax year, which means that small businesses did not have an opportunity to adopt qualifying arrangements before the 2010 tax year began. The IRS has promised to issue transition relief for the 2010 tax year, to make it easier for small businesses to have qualifying arrangements. Specifically, an employer that pays at least 50 percent of the premium for each employee enrolled in coverage will not fail to maintain a qualifying arrangement merely because the employer does not pay a uniform percentage of the premium for each such employee. Wells Fargo Insurance Services will inform its customers of this transition relief after IRS releases guidance on this issue.

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