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Small Employer Health Insurance Expense Tax Credit Official IRS Guidance

May 19, 2010

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 was added by the Affordable Care Act.[1] Section 45R makes a tax credit available for employee health insurance premiums to employers with fewer than 25 employees that pay average annual wages of less than $50,000. In large part, the Notice affirms the FAQs published by the IRS on this topic last month,[2] although it does provide some new insights.

Background

Section 45R provides eligible small employers (ESEs) with a tax credit equal to a portion of its health insurance premium expenses. The tax credit is available in two phases with Phase I in effect for taxable years beginning before January 1, 2014 and Phase II in effect for taxable years beginning after December 31, 2013. During Phase I, an ESE may claim a credit of up to 35 percent of its credit-eligible health insurance premium expenses for each taxable year (2010[3]-2013). During Phase II, an ESE may claim a credit of up to 50% of its premium contributions under a qualified health plan offered by the ESE through a State-based Exchange for the first two years during which the ESE offers the Exchange-based plan. For tax-exempt ESEs, the maximum credit percentages are 25 percent during Phase I and 35 percent during Phase II. The Notice provides guidance only on Section 45R as in effect during Phase I.

Summary of the Notice

The Notice 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.

Eligible Small Employers

The Notice restates the requirements for being an ESE as set forth in Section 45R, which are that an ESE must: (i) have fewer than 25 full-time equivalent employees (FTEs) for the taxable year; (ii) have average annual employee wages of less than $50,000 per FTE; and (iii) maintain a "qualifying arrangement." A "qualifying arrangement" is an arrangement under which the employer pays premiums for each employee enrolled in health insurance 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 coverage. According to the Notice, there are five steps in determining whether an employer is an ESE for purposes of the credit:

Step 1 – Determine the number of employees taken into account. Generally, all employees 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. Employers that are members of a controlled group or an affiliated service group are treated as a single employer for determining the number of employees.

Step 2 – Determine the number of hours of service performed by those employees. The Notice states that an employee's hours of service include: (i) each hour for which an employee is paid or entitled to payment for the performance of duties for the employer and (ii) each hour for which an employee is paid, or entitled to payment, by the employer for a period of time during which no duties are performed due to vacation, holiday, illness, incapacity, layoff, jury duty, military duty or leave of absence, up to 160 hours for any single continuous period during which no duties are performed. An employer may determine hours of service from records of hours worked and hours for which payment is made or by using an equivalency method (8 hours for each day or 40 hours for each week during which the employee is entitled to payment for at least one hour of service under (i) or (ii) above).

Step 3 – Calculate the number of the employer's FTEs. To determine an employer's FTEs, the total hours of service (as determined under Step 2) credited to employees taken into account for purposes of the credit (as determined under Step 1), limited to 2,080 hours per employee, is divided by 2,080 (with the result if not a whole number rounded to the next lowest whole number).

Step 4 – Determine the average annual wages paid per FTE. To determine the average annual wages paid by an employer for a taxable year, the total wages paid by an employer during the taxable year to employees taken into account for purposes of the credit (as determined under Step 1) are divided by the number of the employer's FTEs for that year (as determined under Step 3). Wages means wages for FICA purposes, disregarding the wage base limitation (and include only wages paid for hours of service under Step 2).

Step 5 – Determine the employer's credit-eligible health insurance premium expenses. An employer's credit-eligible health insurance premium expenses are those that it pays under a qualifying arrangement for health insurance coverage that meets the requirements of Section 45R. Note that only the employer's share of the premium is counted for purposes of the credit and that any portion of the premium paid through a salary reduction arrangement under a Section 125 cafeteria plan is not treated as paid by the employer. For years prior to 2014, health insurance coverage means medical insurance plans, limited scope dental or vision plans, long-term care plans, nursing home care plans, home health care plans, community-based care plans, specified disease or illness insurance plans, hospital indemnity insurance plans, Medicare supplemental health insurance plans and other supplemental insurance plans. The different types of plans are not aggregated for determining whether the employer pays at least 50% of the premium costs of the plan. The amount of the premiums that an employer may take into account in calculating the credit is capped at the premium payments the employer would have made under the same arrangement if the average premium for the small group market in the State in which the employer offers coverage were substituted for the actual premium.[4]

Calculating the Credit

The Notice breaks down the credit calculation into three steps.

Step 1 – Calculate the maximum amount of the credit. As has been mentioned, for taxable years beginning in 2010 through 2013, the maximum credit is 35 percent of an ESE's credit-eligible premium expenses. Tax-exempt ESEs may claim a credit of up to 25 percent of its credit-eligible premium expenses, not to exceed the total amount of income and Medicare taxes withheld from employees' wages plus the ESE's share of Medicare tax on employees' wages for the year.

Step 2 – Reduce the maximum credit in accordance with the phaseout rule, if necessary. The amount of the tax credit is reduced for an ESE with more than 10 FTEs or with average annual wages greater than $25,000, and is eliminated for an ESE with 25 or more FTEs or average annual wages of $50,000 or more. If an ESE has more than 10 FTEs and average annual wages greater than $25,000, then the ESE's credit amount is subject to two reductions: one for FTEs in excess of 10 and one for average annual wages in excess of $25,000.

Step 3 – Determine an ESE's actual premium payment, if the ESE receives a State tax credit or subsidy for health insurance. If an ESE receives a State tax credit or subsidy for health insurance, then the amount of credit that the ESE can claim is limited to the ESE's net premium payment (*i.e.*, the ESE's premium payment excluding the State tax credit or subsidy).

Claiming the Credit

An ESE claims the health insurance premium expense credit on its annual income tax return, offsetting its actual tax liability for the year. The credit is a general business credit, so any unused credit amount can be carried back one year and carried forward 20 years (except that any unused credit amounts for 2010 can only be carried forward). The IRS will provide further information on how tax-exempt ESEs claim the credit, although the Notice states that the credit is refundable for tax-exempts.

The credit can be reflected in determining estimated tax payments for the year in which the credit applies in accordance with regular estimated tax rules. It also can be used to offset an ESE's alternative minimum tax liability for the year. An ESE may not take a deduction for the portion of its health insurance premiums that is equal to the amount of the credit.

2010 Transition Relief

As discussed above, the Notice requires that to be an ESE an employer must maintain a "qualifying arrangement," which means that the employer must pay a uniform percentage of not less than 50 percent of the premium cost of health insurance coverage. This is referred to as the "uniformity requirement." For taxable years beginning in 2010 only, an employer that pays an amount equal to at least 50% of the premium for single coverage for each employee enrolled in coverage will be deemed to satisfy the uniformity requirement. Thus, for 2010 only, an employer can pay a lesser percentage for employees enrolled in family coverage than it pays for employees enrolled in single coverage, as long as the employer pays an amount equal to at least 50 percent of the single coverage premium.

Outstanding Issues

Although the Notice provides clarification on some points not previously addressed, a number of issues remain unresolved, including the following:

- It is noteworthy that the guidance is silent as to whether an employer contributing to a multiemployer health plan can qualify as an ESE if it otherwise meets the requirements of Section 45R.
- Section 45R and the Notice appear to make the credit available only to employers that maintain fully-insured group health plans, as opposed to self-funded plans. Thus, it appears that employers maintaining self-insured group health plans may not take advantage of the credit.
- Some employers offer different benefit options and coverage levels under their plans and pay an amount for each employee that is equal to a specified percentage of the cost of the lowest-cost option and coverage level (even if an employee chooses a higher-cost benefit option or coverage level). Under current guidance, it is likely that an employer that pays at least 50% of the single coverage premium for the lowest-cost option even for employees enrolled in a higher-cost option will not satisfy the uniformity requirement (including under the transition relief for the 2010 taxable year).
- It is also not entirely clear whether an employer that does not qualify for the credit because it does not pay at least 50 percent of the premium costs of the plan for a

portion of the year, but then increases its contribution level so that it meets this eligibility requirement for the remainder of the year (assuming all other eligibility requirements are met), may claim the credit for a portion of the year by only taking into account the contributions made for the months that the employer does pay at least 50 percent of the premium costs of the plan.

We will monitor these and all other issues related to Section 45R and health care reform, and provide updates as guidance becomes available.

[1] "Affordable Care Act" means The Patient Protection and Affordable Care Act (PPACA) and the Health Care and Education Reconciliation Act of 2010 (HCERA).
[2] Go to http://www.irs.gov/newsroom/article/0,,id=220839,00.html (as visited on May 18, 2010).
[3] An ESE may claim the credit with respect to all premiums it paid during 2010, including premiums paid prior to enactment of the Affordable Care Act.
[4] See Rev. Rul. 2010-13 for a listing of the average premium rate for each State.

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