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LEGAL ALERT

Legal Alert: IRS Releases Further Guidance Regarding the Small-Employer Tax Credit

6/1/2010

On Monday, May 17, the Internal Revenue Service issued Notice 2010-44[1], which provides clarification and further guidance for the "small employer tax credit" that was added to the Internal Revenue Code by the Patient Protection and Affordable Care Act (PPACA). Section 45R of the Internal Revenue Code was added to provide a refundable tax credit to small employers that provide health insurance to their employees. According to the IRS the credit is supposed to provide an incentive for small businesses to provide – or continue to provide – health insurance coverage to their employees, who might otherwise go without coverage. The new provision became effective for employers' taxable years beginning after December 31, 2009, so it is currently effective. Millions of small employers have already received postcards from the IRS notifying them of the existence of this new credit, and informing them what they have to do in order to take advantage of it. The Notice addresses several issues that need to be resolved but that thus far were still uncertain. Small employers may qualify for a tax credit in order to help pay for health insurance premiums for their employees. Until 2014, the credit will equal up to a maximum of 35% of the employer's payments for employee health insurance premiums, but not to exceed 35% of the average cost (according to IRS tables) of a ""small" group insurance plan in the employer's geographic market. (For tax exempt organizations – most of which are also eligible for the credit – the credit percentage is 25%.) When the newly-created health insurance "exchanges" go into effect in 2014, the credit will be available for only two more years, and the maximum will increase to 50% (35% for tax-exempt organizations), but will only apply to premiums paid for insurance that is purchased through one of the "exchanges" (which is supposed to help transition employees to using exchange-provided coverage). In order to qualify for the credit, the employer must directly pay at least 50% of the premium for employee coverage (i.e., not counting premiums that are funded through employees' salary reductions, such as under a cafeteria plan), and the employer's payment towards each employee's coverage must be a uniform percentage of the premium. For employers other than tax-exempt organizations, the credit is eligible to be applied against regular income tax or the alternative minimum tax. It is not a refundable credit, but as part of the general business credit it can be carried back to the preceding year (but not earlier than 2010) and can be carried forward for up to twenty years. In the case of a tax-exempt employer, the credit is refundable and is applied against certain of the employer's payroll tax liabilities, *i.e.*, income tax required to be withheld and both the employer and the employee shares of the Medicare portion of FICA tax (the Old-Age, Survivors and Disability Insurance – OASDI – portion of

FICA tax is not eligible to be reduced by the credit). The tax credit was publicized as being available to employers with fewer than 25 full-time equivalent (FTE) employees whose average annual wage is less than $50,000 per FTE, but that does not mean that it will be available to all employers with fewer than 25 FTEs and less than $50,000 in average annual wages. The credit begins to phase out once the employer has more than 10 FTEs *or* pays an average annual wage of $25,000; a combination of the two phaseouts can completely eliminate the credit before the employer has reached either 25 FTEs or $50,000 in average annual wages. Furthermore, the credit cannot be claimed by the self-employed, and business owners (and their families and dependents) cannot be taken into account as "employees." The Notice contains step-by-step procedures for determining whether a business is eligible for the credit, and if so, the amount. This requires that the business determine the number of its FTEs, as well as their average annual wages. First, the number of employees must be determined. As mentioned above, business owners (including partners and sole proprietors) and their family members and dependents are not taken into account as employees, and premiums paid for their coverage are disregarded. Occasional or seasonal workers who do not work more than 120 days per year are also disregarded in counting FTEs, but premiums paid for them *are* taken into account in determining the amount of the credit. Employees of commonly-controlled businesses, or affiliated service groups, are required to be aggregated when determining eligibility; as a result, if a business has 10 full-time employees but is a part of a controlled group having a total of 30 full-time employees, the 10-employee business is not an eligible employer. Next the number of hours of service for all employees is determined and totaled. For this purpose, the qualified pension plan rules realting to hours of service generally apply. So an "hour of service" includes each hour for which the workers are paid for performing duties, as well as for reasons other than performing duties, such as paid vacation, illness, holiday or other paid leave time. Instead of counting employees' actual hours, an employer has the option to calculate the total number of hours of service by using days-worked or weeks-worked "equivalencies", counting any day in which the employee has any paid hours as 8 hours or any week in which the employee is paid for an hour as 40 hours. (This is in contrast to the more generous "retirement plan" hour-of-service equivalencies of 10 hours per day or 45 hours per week. However, whereas a larger number of hours is generally advantageous in the retirement plan context, here a lesser number of hours will create more eligibility; hence the smaller equivalencies work to everyone's advantage.) Once the total number of employees' hours of service is known, that total number is divided by 2080 (40 hours per week times 52 weeks) in order to determine how many full-time employees the total represents, and that number, rounded down to the next lower whole number, is the number of the employer's "full-time-equivalents" (FTEs) for eligibility purposes. The annual wages paid to all employees (excluding owners and their family members and dependents) are then totaled, divided by the computed number of FTEs and rounded down to the next lower multiple of $1000 in order to determine the average annual wage of the employer's FTEs. Next, the amount of the premiums actually paid by the employer for eligible employees' coverage (but not including amounts paid for owners and their families or dependents) have to be totaled in order to determine the amount of the credit that is allowable to the employer. Premiums paid for occasional or seasonal workers' coverage can be included. The total also includes not only premiums for hospitalization or major medical insurance, but also includes premiums that are paid by the employer for coverages such as dental, vision, long-term care, Medicare supplement policies, and certain other limited-coverage insurance. The uniform-percentage and 50%-payment requirements that are discussed above must be met separately for each type of coverage for which a credit is sought. And you have to keep in mind that the amount of employer payments that can be taken into account for purposes of computing the credit cannot exceed the average premium determined for small group coverage in the employer's geographical rating area, but that premium cap is an overall limitation, and does not have to be separately applied to each separate type of coverage provided. The Notice contains a listing of those average premium rates by State, though the geographic areas may yet be further subdivided – into cities, counties, etc. – where appropriate. The next step is the actual calculation of the credit amount. The employer's computed premium is multiplied by the applicable credit percentage (currently 35% for taxable businesses, 25% for tax exempt organizations); this gives the employer's maximum credit amount. This maximum credit for a tax exempt organizations is also limited to the sum of (i) the taxes withheld by the employer plus (ii) the employer's share of Medicare tax, since the organization's credit will have to be set off against those amounts. The resulting maximum credit is then reduced by one fifteenth (1/15) for each of the employer's FTEs over 10 FTEs; for example, if the employer computed a total of 16 FTEs, the maximum credit would be reduced by 40% (i.e., (16 - 10) x (1/15)). Next the remaining amount is reduced by an amount equal to the product of the original maximum credit (i.e., before the reduction for FTEs), times the fraction (i) the average annual wage in excess of $25,000, over (ii) $25,000; for example if the average annual wage of the employer's FTEs were $30,000, this reduction would be an additional 20% of the originally-computed maximum credit (i.e., ($30,000 - $25,000) ÷ $25,000). As a result of these reductions, the credit disappears entirely if either the employer has 25 or more FTEs, or the FTEs have average annual wages of $50,000 or more. However, since the two reductions are computed independently of each other, two "partial" reductions can reduce the credit to zero, even if the employer has fewer than 25 FTEs with average annual wages of less than $50,000. For example, 20 FTEs with $40,000 of average annual wages will result in a credit of zero. The Notice also provides that, in the approximately 20 States that provide some kind of subsidy or tax credit for employer-provided coverage, those State benefits are not subtracted from the Federal credit so long as the total amount of the credit is not more than the amount of premium that the employer actually pays. In other words, the employer may recover its entire cost, but the credit is not supposed to provide the employer with a windfall profit, or effectively turn into a refundable credit. The small employer tax credit is already in effect and employers may immediately begin reducing their estimated tax payments to reflect the amount of their expected credit. For 2010 – referred to as the "transition year" – the uniformity-of-contribution requirement is waived so long as the employer pays at least an amount equal to 50% of the premium for single coverage for each employee (even for employees who have family coverage).

If you have any questions regarding this Alert, or would like additional details concerning the Notice or concerning the matters discussed above, you can contact the author of this Alert, Jeffrey Ashendorf, 212-453-5926, jashendorf@fordharrison.com, any member of Ford & Harrison's Employee Benefits practice group or the Ford & Harrison attorney with whom you usually work.

[1] The Notice was issued in the June 1 *Internal Revenue Bulletin*.