



SMALL BUSINESS HEALTH CARE TAX CREDIT

HEALTHPASS HEALTH REFORM BRIEF

On March 23, 2010 President Obama signed into law the Patient Protection and Affordable Care Act of 2010 (PPACA), which created a new tax credit for small businesses that provide health insurance coverage to their employees. This HealthPass policy brief outlines which small businesses may be eligible for the credit, how the credit amount is calculated, and other relevant information.

ABOUT THE SMALL BUSINESS HEALTH CARE TAX CREDIT

As part of the recently passed federal health care reform package, certain small businesses may be eligible for a tax credit designed to encourage employers to purchase health insurance for employees. The Internal Revenue Service (IRS) estimates that 4 million small businesses may qualify for the tax credit. Small businesses may begin claiming the tax credit in the 2010 taxable year.

The tax credit will be available in **two phases**:

- **Phase I:** From 2010 to 2013, the credit will be worth up to 35 percent of the employer contribution. For eligible tax-exempt organizations, the credit is worth up to 25 percent of the employer contribution.
- **Phase II:** Beginning in 2014 when new health insurance exchanges are up and running, the credit will be increased to 50 percent for businesses and 35 percent for tax-exempt organizations, but will be available only to small businesses that purchase health insurance coverage **through a health insurance exchange**. The credit will expire after the employer has received the credit for two years.

ELIGIBILITY

To qualify for the tax credit, a small business must:

- Cover at least 50 percent of the cost of health care coverage for its workers
- Have less than the equivalent of 25 full-time workers (FTEs) (an employer with less than 50 full-time workers, for example, may be eligible)
- Pay average annual wages below \$50,000
- Be either a taxable or tax-exempt organization (i.e., a 501(c) organization)

The **full credit**, both before and after 2014, is available only to employers with 10 or fewer FTEs whose average annual wages do not exceed \$25,000. The credit phases out as the number of employees and average annual wage increases. Premiums paid using funds from a salary-reduction agreement do not count as part of the 50 percent that must be contributed by the employer. Employers also must pay a uniform percentage of the premium cost for all workers.

Self-employed individuals do not qualify for the credit and it covers only employees, not owners or their families.

CALCULATING THE CREDIT AMOUNT

A [notice issued by the IRS](#) on May 17th, 2010 describes the step-wise process by which a small business can determine its eligibility for the tax credit. That recommended process—followed by a more detailed description of each step—is below:

1. Determine the employees who are taken into account for purposes of the credit
2. Determine the number of hours of service performed by those employees
3. Calculate the number of the employer's FTE employees
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

Determine the employees taken into account for calculating the credit

Partners in a partnership, sole proprietors, owners, and shareholders owning more than two percent of an S corporation are not counted for purposes of calculating the credit. Owners' family members and dependents are also not counted. Seasonal workers who do not work more than 120 days per year are excluded, too. Employees of controlled or affiliated service groups are counted and aggregated for determining eligibility.

Determine the number of hours of service performed by employees

In calculating employees' hours of service performed, an employer must include the hours employees are actually paid for performance of duties as well as any paid vacation, holiday, illness, jury duty, layoff, or military duty. To calculate the total number of hours which must be taken into account for each employee, the small business may either determine the actual number of hours for which payment is made or due or use a days-worked or weeks-worked equivalent whereby the employee is credited for 8 hours for any day or 40 hours for any week in which an employee would be credited with at least one hour of work.

Calculate the number of FTE employees

To determine a small business's FTEs for eligibility purposes, divide the total hours of service by 2,080 (derived from 40 hours/week multiplied by 52 weeks/year). If the result is a fraction, round it to the next lowest whole number. In some instances, a small business with more than 25 employers may actually qualify if it employs a number of part-time workers.

Example: Determining the number of FTEs:

- For the 2010 taxable year, an employer pays 7 employees wages for 2,080 hours each, 5 employees wages for 1,040 hours each, and 3 employees wages for 2,300 hours.
- The employer's FTEs would be calculated as follows:
 - Total hours of service **not exceeding 2,080 per employee** is the sum of:
 - 14,560 hours of service for the 7 employees paid for 2,080 hours each (7 x 2,080)
 - 5,200 hours of service for the 5 employees paid for 1,040 hours each (5 x 1,040), and
 - 6,240 hours of service for the 3 employees paid for 2,300 hours (3 x 2,080 (lesser of 2,300 and 2,080)).
 - The sum of the above hours equals 26,000 hours of service.
 - FTEs equal **12** (26,000 divided by 2,080 = 12.5, rounded to the next lowest whole number).

Determine the average annual wages paid per FTE

To determine the average annual wages paid to employees (and not owners or their families), divide the total wages paid by an employer during a taxable year by the number of FTEs for the year. If the result is not a multiple of \$1,000, round it down to the nearest \$1,000.

Determine the applicable premiums paid by the employer

Only health insurance premiums paid by the employer are counted in calculating the tax credit; employee contributions are not counted. Any premiums paid using funds using a salary-reduction agreement are also not treated as paid by the employer, and thus are not counted. All premiums paid by the employer in taxable year 2010 count, even premiums paid prior to the passage of health reform (March 23, 2010).

In addition to premiums paid for hospital and medical insurance, premiums paid by the employer for dental, vision, long-term care, Medicare supplemental coverage, home care, and other limited scope coverage are counted as well. These different types of health insurance, however, are not aggregated for purposes of determining eligibility. The employer must separately satisfy the uniform percentage of premium contribution and 50 percent payment requirements for each form of insurance for which they seek a credit.

The amount of an employer's premium payments counted in determining the credit is capped at an amount that the employer would have paid if the average premium for the small group market in the employer's state (or a sub-area within a state, as determined by the IRS) were substituted for the actual premium. For **New York** (state), this amount is \$5,442 for single coverage and \$12,867 for family coverage. This cap applies overall to all health insurance coverage, and not separately to each form of insurance offered. Rates for other states can be found in an [IRS revenue ruling](#).

Calculate the actual credit amount

In general, the following two steps are used in determining the actual credit amount:

1. Calculate the maximum amount of the credit (section III.B);
2. Reduce the maximum credit in step 1 in accordance with the phase-out rule, if necessary.

To calculate the credit, multiply the premiums actually paid by the employer by the applicable credit percentage (35% for taxable small businesses and 25% for tax-exempt organizations) to determine the maximum possible credit. For tax-exempt entities, the credit cannot exceed the sum of the income taxes withheld by the employer plus both the employee and employer shares of the Medicare tax.

Entities that do not qualify for the maximum credit (i.e., if they have more than 10 FTEs and/or pay average annual wages above \$25,000), must also calculate the credit reduction. The maximum credit is reduced by either:

- the credit amount multiplied by a fraction, the numerator of which is the number of FTEs in excess of 10 and the denominator of which is 15, or
- the credit amount multiplied by a fraction, the numerator of which is the amount by which average annual wages exceed \$25,000 and denominator of which is \$25,000.

For entities that have both FTEs greater than 10 and average annual wages greater than \$25,000, the credit is reduced by the sum of the above two calculations.

Example: Calculating the credit phase-out if the number of FTEs exceeds 10 and average annual wages exceed \$25,000

- For the 2010 taxable year, a taxable eligible small business:
 - has 12 FTEs,
 - pays average annual wages of \$30,000
 - pays \$96,000 in health insurance premiums for its employees (which does not exceed the average premium for the small group market in the employer's State)
- The credit is calculated as follows:
 - Initial amount of credit before any reduction: $(35\% \times \$96,000) = \$33,600$
 - Credit reduction for FTEs in excess of 10: $(\$33,600 \times 2/15) = \$4,480$
 - Credit reduction for average annual wages in excess of \$25,000: $(\$33,600 \times \$5,000/\$25,000) = \$6,720$
 - Total credit reduction: $(\$4,480 + \$6,720) = \$11,200$
 - Total 2010 tax credit equals **\$22,400** $(\$33,600 - \$11,200)$.

A small business cannot claim the credit if it employs more than 25 FTEs and pays average annual wages over \$50,000. Some small businesses receive state tax credits or premium subsidies for providing health insurance to their employees. These state-based credits and/or subsidies do not reduce the federal tax credit amount so long as the federal credit does not exceed the amount that the employer actually pays.

CLAIMING THE CREDIT

The small business health care tax credit may be used to pay off income tax owed (including the alternative minimum tax (AMT)). If the small business has no taxable income in the year in which it wishes to receive the credit, it may carry the credit forward for 20 years or backwards one year (after 2010). Qualified tax-exempt organizations may use the credit to offset withholding and Medicare taxes that they owe on behalf of their employees. The credit can be claimed on an employer's annual income tax return. To provide transition relief in 2010, the requirement that the employer must pay a uniform percentage of the premium cost for all workers is waived so long as the employer pays at least 50 percent of the premium for single coverage for each employee (even if an employee is enrolled in family coverage).

Additional information on the tax credit, including frequently asked questions (FAQ's) and a YouTube primer, can be found on the IRS website at: <http://www.irs.gov/newsroom/article/0,,id=223666,00.html>. A brief FAQ's on the credit can be found on the HealthPass website at <http://www.healthpass.com>.

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HealthPass is a New York-based commercial health insurance exchange serving sole proprietors and small businesses. Begun in 1999 as an innovative collaboration between New York Business Group on Health, the City of New York, and the health insurance industry, HealthPass offers employees the ability to choose, from an ever-growing menu, the healthcare insurance option that fits their needs and budget. With access to over 200,000 doctors, dentists, nurses and other healthcare professionals, HealthPass provides greater network flexibility than any single plan. HealthPass currently serves all five boroughs of New York City, Long Island, and the counties of Westchester, Rockland, Orange, Putnam, Dutchess, Ulster, and Sullivan.

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