

May 25, 2010

## MEMORANDUM TO CLIENTS

**RE: IRS Notice Provides Guidance on Small Business Health Insurance Tax Credit**

On May 17, 2010, the Internal Revenue Service ("IRS") issued [Notice 2010-44](#) (the "Notice"), which provides important details on who can claim the small business health insurance tax credit added by the Patient Protection and Affordable Care Act (the "Credit") and how the Credit is calculated and claimed. The Notice follows on the heels of the issuance of [Revenue Ruling 2010-13](#) and a [frequently asked questions](#) document on the IRS website, as well as an extensive IRS educational campaign intended to encourage small employers to retain (or add) health insurance coverage for their employees. A summary of the Notice is set forth below. We anticipate additional guidance, and the IRS expressly requested comments.

**Who is Eligible for the Credit?** To be eligible for the Credit, an employer must be an "eligible small employer" for the year – requiring all four of the following criteria to be satisfied:

1. taxable employer or a 501(c) tax-exempt employer (e.g., colleges and universities);
2. fewer than 25 full-time equivalent employees ("FTEs") for the taxable year;
  - **FTE:** In order to determine the number of FTEs, the employer must divide the total "hours of service" (but not more than 2,080 hours for an employee) performed by "employees" by 2,080, and round down to the next lowest whole number.
  - **Employees:** For these purposes, take into account employees who perform services for the employer (which is a controlled group concept), excluding (1) partners, sole proprietors, 2% S-corp. owner, and 5% owners (along with any family members of those owners and partners), and (2) seasonal employees unless they work more than 120 days during the taxable year. (Note, any premiums paid on behalf of such seasonal employees may be taken into account in calculating the amount of the credit, but any premiums paid on behalf of such owners and partners are disregarded.)
  - **Hours of Service:** Hours of service include (1) each hour for which an employee is paid, or entitled to pay, for work performed; and (2) each hour for which an employee is paid, or entitled to pay, for periods the employee did not perform work due to a vacation, holiday, illness, incapacity disability, layoff, jury duty, military duty or leave of absence (maximum 160 hours for a single continuous period). The calculation of actual hours worked may be a challenge depending on the employer's payment methods and payroll records. The Notice therefore permits using either an 8 hours/day or 40 hours/week equivalency. (We recommend reviewing the available options with the employer's payroll department.)
3. "average annual wages" for FTEs of less than \$50,000; and

- Average Annual Wages: The employer divides the total wages subject to FICA (without regard to the wage base limitation) paid by the employer to employees for the "hours of service" taken into account during the taxable year, by the number of FTEs, rounded down to the nearest \$1,000. (Note, this may not simply line up with box 5 of the Form W-2 because this is only wages attributable to "hours of service.")
4. "health insurance coverage" paid for by employer through a "qualifying arrangement."
- Health Insurance Coverage: For taxable years before 2014, the Notice provides an expansive list of health insurance coverage, including HMO/PPO, dental, vision, long-term care, nursing home care, specified disease or illness, hospital indemnity, and Medicare supplemental. The list excludes, among other things, accident or disability insurance, worker's compensation insurance and coverage for on-site medical clinics. Importantly, the credit only covers employer-paid premiums and does not include employee pre-tax or post-tax payments (e.g., section 125 payments are not eligible). Also, it does not apply to self-funded plans. In general, State tax credits or premium subsidies are counted as employer paid premiums and will not negatively affect the amount of the Credit.
  - Qualifying Arrangement: The employer pays a uniform percentage of not less than 50% of the premium cost for the coverage. (Each type of coverage is tested separately for this purpose.) For 2010, the employer only needs to pay an amount equal to at least 50% of the premium for single (employee-only) coverage for each enrolled employee, and all premiums paid in 2010 will count (even if paid prior to the March 23, 2010 enactment date).
- **What is the Amount of the Credit?** The maximum Credit is currently 35% of the employer paid "health insurance coverage" premiums (25% for tax-exempt employers). The maximum Credit is increased to 50% beginning in 2014 (35% for tax-exempt employers), but will only be available if the coverage is purchased through an Exchange. Beginning in 2014, the credit is only available for two consecutive years. Importantly, the Credit is phased out rather quickly if the employer has more than 10 FTEs or the "average annual wages" exceed \$25,000. The following steps can be taken to calculate the 2010 Credit:

- Step 1: Determine that you meet the definition of "eligible small employer" for the year.
- Step 2: Determine the employer portion of the premium paid for the year for each "employee" (which includes any State subsidy).
- Step 3: Take the lesser of Step 2 amount or the employer's percentage of average small group market rates set forth in Revenue Ruling 2010-13 (by State) for each "employee" and aggregate these amounts.
- Step 4: Multiple Step 3 amount by 35% (25% for a tax-exempt employer).

Step 5: For a tax-exempt employer, enter the smaller of Step 4 amount or the aggregate federal income tax withholding and employer and employee share of Medicare taxes paid/withheld for the year (which will likely require a review of Form 944 and again help from the employer's payroll department). For a taxable employer, enter the amount from Step 4.

Step 6: Reduce Step 5 amount by the sum of: (1) if more than 10 FTEs:  $(FTE - 10)/15 \times \text{Step 5}$ , and (2) if "average annual wages" exceeds \$25,000:  $(\text{"average annual wages"} - \$25,000)/\$25,000 \times \text{Step 5}$ . (If negative, then the Credit is zero and stop here.)

Step 7: Reduce Step 6 amount to not exceed the employer's net premium payments if State credits or subsidies for health insurance are available to the employer (e.g., amount actually paid by the employer excluding the State subsidy).

- **How is the Credit Claimed?** For taxable employers, the Credit is claimed on the employer's annual income tax return (e.g., Form 1120 and presumably Form 3800) as a nonrefundable general business tax credit (which can be carried forward 20 years and may offset AMT). Note that a deduction for the health care costs is not permitted for the amount of the Credit, which should be considered when determining the value of the Credit. For tax-exempt employers, the IRS is still working on how to claim the refundable credit (e.g., likely Form 990-T to offset unrelated business income tax or result in a refund, but for small employers that may rarely file Form 990-T, a new schedule to Form 990/990-EZ would be preferred). When valuing the Credit for these employers, the loss of the deduction is not a factor but the Credit is limited to the annual employment taxes (federal income tax withholding and employer and employee share of Medicare tax), which may impact the value of the Credit. Importantly, for all employers, the Credit has no impact on employment tax forms/deposits (e.g., no impact on Form 944 or related deposits), which is a helpful clarification.

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