GROOM LAW GROUP

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MEMORANDUM

RE: IRS Provides Further Guidance on Operation of the Small Business Health Insurance Tax Credit

The small business health insurance tax credit was added by the Patient Protection and Affordable Care Act to provide a tax credit for eligible small businesses that provide health insurance coverage to their employees (the "Credit"). The Credit is available for taxable years beginning after December 31, 2009. The Internal Revenue Service ("IRS") previously issued guidance on who is eligible for the Credit and how the Credit is calculated. (See Groom memorandum to clients dated May 25, 2010 for a summary of that guidance. http://www.groom.com/resources-499.html) Recently, the IRS released Notice 2010-82 (the "Notice" (http://www.irs.gov/pub/irs-drop/n-10-82.pdf)) which expands on the previous guidance issued regarding the Credit through 2013. The following provides a summary of this additional guidance. (Information on the Notice is also included in the recently updated IRS FAQs online at http://www.irs.gov/newsroom/article/0,,id=220839,00.html.)

Operation of the Credit

Only eligible small employers may claim the Credit. An eligible small employer has fewer than 25 full-time employees where the average annual wages for employees is less than $50,000 per full-time employee and the employer maintains a qualifying arrangement. To be a qualifying arrangement, the employer must pay health care insurance premiums for each employee enrolled in an amount equal to a uniform percentage (of not less than 50 percent) of the premium cost of the coverage.

Employers Eligible for the Credit

Tax-Exempt Employers. Tax-exempt employers are eligible for the Credit as long as they are a small organization described under section 501(c) of the Internal Revenue Code (the "Code") which is exempt from taxation under section 501(a) of the Code. The Notice makes it clear that other tax-exempt organizations are not eligible for the Credit. The IRS also released Form 8941 (http://www.irs.gov/pub/irs-pdf/f8941.pdf) and a revised draft Form 990-T for tax-exempt employers to use to claim the Credit (http://www.irs.gov/pub/irs-dft/f990t--dft.pdf).

Household Employees. The IRS states that the employer does not have to be in a trade or business in order to be eligible for the Credit. Consequently, an employer of household employees could be eligible for the Credit if that employer otherwise met the requirements for the Credit.

Employers Located Outside the United States. Small employers located outside of the United States that have income effectively connected with the conduct of a trade or business in the United States may be eligible for the Credit if the qualifying coverage is purchased is from an insurer regulated by one of the fifty states or the District of Columbia.

Employees Taken Into Account for the Credit

Spouses of Business Owners. In determining the eligibility for and the amount of the Credit, employees who are also business owners (sole proprietors, partners, 2% owners in a S corporation or 5% owners) are excluded in determining the number of full-time employees, the average wages and the health insurance premiums paid. Family members of these owners are also not taken into account; however, in the Notice the IRS notes that section 45R of the Code does not specifically address whether spouses should also be excluded. Consequently, the Notice clarifies that the spouses of certain business owners (sole proprietors, 5% partners, 2% owners in a S corporation or 5% owners) should not be included in determining the eligibility for and amount of the Credit.

Leased Employees. Leased employees, as defined in section 414(n) of the Code, are counted in determining the number of full-time employees and the average annual wages. The Notice states that only premiums that the employer actually pays for these leased employees is counted in determining the amount of the Credit. Consequently, if the leasing organization pays the premiums for the health insurance of the leased employees, the service recipient organization will have to include these leased employees in determining the number of employees and their annual wages in determining eligibility for the Credit, but will not be able to include the health insurance premiums paid by the leasing organization for coverage of these employees toward the amount of the Credit.

Other Employees Taken Into Account. The Notice clarifies that employees that were terminated during the year, employees covered under a collective bargaining arrangement and employees who do not enroll in their employer's health insurance plan are counted for purposes of determining the number of full-time employees and the average annual wages. The Notice also provides guidance on how ministers are taken into account for purposes of the Credit.

Calculating Average Annual Wages, Number of Hours Worked and Number of Full-Time Employees. In determining the number of full-time employees, 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 (rounded down to the next whole number). The Notice clarifies that for calculating average annual wages, all wages (including overtime pay), including wages paid to an employee for hours in excess of the 2,080 hour cut-off, are taken into account. Notice 2010-44 provides three alternative methods for calculating employees' hours of service: actual hours worked, days worked equivalency and weeks worked equivalency. The Notice clarifies that an employer can apply different methods for different classifications of employees (e.g. hourly vs. salaried) so long as the classifications are reasonable and consistently applied, and the employer can change methods annually.

Qualifying Arrangements

HRAs, FSAs, HSAs and Self-Insured Plans. Only arrangements where the employer pays premiums for an employee to be enrolled in health insurance coverage will be considered a qualifying arrangement. Consequently, self-insured arrangements will not be considered a qualifying arrangement. The IRS states that health reimbursement arrangements ("HRAs") and

health Flexible Spending Arrangements ("FSAs") are self-insured plans and are not considered a qualifying arrangement. Contributions to a Health Savings Account would also not be considered a qualifying arrangement, although the employer's contribution toward the high deductible health insurance should be considered a qualifying arrangement.

Multiemployer Health and Welfare Plans. Contributions by an employer to a multiemployer plan that are used to pay premiums for health insurance coverage for employees covered by the plan are treated as the payment of health insurance premiums by the employer. However, the Notice states that a contribution to a multiemployer plan that is self-insured is not considered a qualifying arrangement. For those multiemployer plans that provide welfare-type benefits (e.g. life insurance or short-term or long-term disability benefits) through the plan in addition to health benefits, only the employer contributions that are used to purchase health insurance are counted in determining the amount of the Credit. Therefore, plans that provide these additional welfare-type benefits will need to allocate contributions among the benefits provided. The Notice states than an employer that contributes to the multiemployer plan is permitted to rely on the information provided by the plan to determine the amount of the contribution used to purchase health insurance.

Church Plan Coverage. The Notice provides that self-insured church welfare benefit plans, which are subject to state insurance law enforcement as if they are licensed insurance companies, are treated as health insurance coverage for purposes of the Credit.

Application of the Uniformity Requirement

To be a qualifying arrangement eligible for the Credit, the employer must pay a uniform percentage of not less than 50 percent of the premium cost of the health insurance coverage (except that Notice 2010-44 provides certain transition relief for 2010). The Notice provides rules for applying the uniformity requirement for taxable years beginning after 2009 and before 2014. (After 2013, the Credit is only available if insurance is purchased through an exchange.) For 2010, an employer may satisfy the uniformity requirement by meeting either the requirements in the Notice or the transition relief for 2010 in Notice 2010-44.

The Notice provides guidance and examples regarding the application of the uniformity requirement, including with respect to: employers offering a single health insurance plan; employers offering more than one plan; employers offering a more expensive tier of coverage than single coverage (e.g., family coverage); employers whose health insurer uses "composite billing" (i.e., a uniform premium for each employee or a single aggregate premium for the group of covered employees that the employer may divide up by the number of covered employees to determine the uniform premium); and employers whose health insurer uses "list billing" (i.e., a separate premium for each employee based on the age of the employee and other factors).

The guidance provides employers with some flexibility to satisfy the uniformity requirement by basing its contribution toward the cost of a tier of coverage (e.g., family coverage) that is more expensive than single coverage on the amount it contributes toward single coverage.

Limitation on the Credit

The Credit is limited by the average premium for the small group market in the state (or area within the state) in which an employee enrolls for coverage. Revenue Ruling 2010-13 (described in our May 25, 2010 memorandum) lists the applicable average premium for employee-only and family plans in the small group market in each state for the 2010 taxable year. The Notice clarifies that (1) if an employer has employees in more than one state; the employer applies the average premium limitation separately for each employee based on the average premium for the state in which the employee works, and (2) the limitation (employee-only or family) for each employee is based on the coverage option elected by the employee and is not affected by whether the employer determines its contribution for family coverage based on its contribution for employee-only coverage.

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