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Health Care Reform Provides Tax Credit for Small Employers

A much-welcomed provision aimed at small employers was included in the health care reform law. The new tax credit under Code Section 45R is equal to up to 35% of the premiums paid by small employers on behalf of their employees, and up to 25% of the premiums paid by tax-exempt and nonprofit small employers. The credit will be available through 2013, at which time it is expected that state health insurance exchanges will be available and small employers would transition their employees into an exchange. (In 2014 when the insurance exchanges go online, the tax credit increases to 50% (30% for tax-exempt and nonprofit small employers) for health insurance purchased through an exchange.)

The credit is greatest for small employers—those with 10 or fewer full-time employees—paying annual average wages of \$25,000 or less. It is phased out completely for employers with more than 25 full-time employees or with average wages of more than \$50,000.

Three Requirements to Qualify. To qualify for the credit an employer (including certain of its related entities) must have fewer than 25 full-time equivalent employees (FTEs); the average annual wages of its employees must be less than \$50,000 per FTE; and its health benefit plan must qualify as a “qualifying arrangement,” which is defined as one in which the employer pays a uniform percentage of at least 50% of the cost of coverage for each employee.

Effective Date. The tax credit is effective for tax years beginning in 2010 through 2013, and is designed to encourage small employers to begin offering health coverage or continue health coverage already in effect.

IRS Notice 2010-44. The IRS recently released Notice 2010-44, in which it provided guidance (and more than a dozen examples) on how to claim the small employer tax credit. The release provides guidance with regard to four issues concerning the credit: (1) the federal credit will never be reduced because an employer receives a state health care subsidy; (2) dental and vision coverage will also be eligible for the tax credit; (3) there is flexibility in how hours worked is calculated (see below); and (4) transition issues (see below).

There are three methods for calculating the number of hours worked per employee in determining whether the employer qualifies as having fewer than 25 FTEs. They are: (1) actual hours of service from records of pay, including payment for illness, vacation, holiday and leave of absence; (2) “days-worked equivalency” by which an employee is credited with 8 hours of service for each day for which the employee would be required to be credited with at least one hour of service; and (3) “weeks-worked equivalency” by which

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an employee is credited with 40 hours of service for each week for which the employee would be required to be credited with at least one hour of service. Certain partners, owners and family members of owners are disregarded for purposes of the tax credit computations, both as regards the hours worked and the wages paid to them, as well as the premiums paid for health care coverage (upon which the credit is computed). Seasonal workers are also disregarded unless they work for an employer on more than 120 days during the year, though premiums paid on their behalf may be counted in the tax credit computation.

For transition purposes, for the 2010 tax year, if an employer pays no less than 50% of the premium for single coverage for each employee enrolled in the plan, the employer will be considered to have met the uniformity requirement for a “qualifying arrangement” even though the employer may not pay the same percentage for each employee.

The 35% credit for taxable small employers is not refundable, but instead is part of the general business tax credit against future taxes, beginning with the 2010 income tax return filed in 2011. Qualifying employers should be able to take it into account when computing estimated tax payments. In contrast, tax-exempt and nonprofit small employers are able to get a refund of the 25% credit. (An employer that is an agency or governmental entity is not eligible unless it is an organization that is tax exempt under Code Section 501(a).) The 25% credit for tax-exempt and nonprofit employers is capped by the amount of withholding tax and the employee and employer portions of the Medicare tax.

Many states provide a subsidy (either a direct payment or tax credit) for employers providing health insurance benefits. Receiving a subsidy from the state will not reduce the amount of federal tax credit, though it should be noted that the federal subsidy is based upon the actual amount paid by the employer (net of the state subsidy).

The IRS expects to provide additional guidance in the near future, especially concerning the application of the uniformity requirement and the 50% requirement for tax years beginning after 2010.

To read IRS Notice 2010-44, click [here](#).

To read the IRS FAQ on the small business health care tax credit, click [here](#).

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