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Small Employers Eligible for Health Care Tax Credit

The Affordable Care Act (ACA) created a **health care tax credit** for eligible small employers that provide health insurance coverage to their employees, effective for tax years beginning after Dec. 31, 2009. The tax credit is designed to encourage small employers to offer health insurance coverage to their employees. In general, the tax credit is available to taxable and tax-exempt small employers that pay at least half the cost of single coverage for their employees.

On June 30, 2014, the Internal Revenue Service (IRS) issued a **final rule** on the ACA's small employer health care tax credit. This rule finalizes a proposed rule that was issued by the IRS on Aug. 23, 2013, with only a few changes and clarifications. The final rule applies for taxable years beginning after 2013. Alternatively, employers may rely on the proposed rule for taxable years beginning after 2013 and before 2015.

OVERVIEW OF HEALTH CARE TAX CREDIT

The health care tax credit is intended to help small businesses and tax-exempt organizations that primarily employ low and moderate income workers provide health insurance coverage to their employees. For the 2010 through 2013 tax years, the maximum credit is **35 percent** of premiums paid for taxable small employers and **25 percent** of premiums paid for tax-exempt small employers.

For 2014 tax years and later, the maximum health care tax credit increases to **50 percent** of premiums paid for taxable employers and **35 percent** of premiums paid for tax-exempt organizations. The tax credit is only available to an employer for two consecutive tax years after 2013 and only when coverage is purchased through an Exchange's Small Business Health Options Program (SHOP).

The maximum credit goes to smaller employers — those with 10 or fewer full time equivalent employees (FTEs) — that pay average annual wages of $25,000 or less ($25,400 or less for 2014).

- For tax years 2010 through 2013, the credit is reduced if the number of FTEs exceeds 10 or if average annual wages exceed $25,000.
- For 2014, the credit is reduced if the number of FTEs exceeds 10 or if average annual wages exceed $25,400.

If an employer pays only a portion of the premiums for the coverage (with employees paying the rest), the amount of premiums counted in calculating the credit is only the portion paid by the employer. For example, if an employer pays 80 percent of the premiums for employee health insurance coverage (with employees paying the other 20 percent), the 80 percent paid by the employer is taken into account when calculating the credit.

The amount of an employer's premium payments that counts for purposes of the credit is capped by the premium payment the employer would have made under the same arrangement if the average premium for the small group market in the employer's geographic location were substituted for the actual premium. The cap that is used for each employee depends on the coverage the employee takes.

Beginning with the 2014 tax year, the amount of an employer's premium payments that counts for purposes of the credit is limited by the average premium in the small group market in the rating area in which the employee enrolls for coverage through a SHOP Exchange.

Example: An employer pays 50 percent of the $7,000 premium for family coverage for its employees ($3,500), but the average premium for family coverage in the small group market in the rating area in which the employees enrolls is $6,000. For purposes of calculating the credit, the employer's premium payments are limited to 50 percent of $6,000 ($3,000).

Both small businesses and tax-exempt organizations use **IRS Form 8941** to calculate the credit. Taxable employers claim the credit on their annual income tax return to offset their tax liability for the year. Tax-exempt organizations must file an **IRS Form 990-T** to claim the health care tax credit. For tax-exempt employers, the credit is refundable, so that an employer without taxable income may receive a refund (as long as it does not exceed the employer's total income tax withholding and Medicare tax liability for the year).

Also, claiming the credit will affect an employer's deduction for health insurance premiums. The amount of premiums that can be deducted is reduced by the amount of the credit.

DETERMINING ELIGIBLITY FOR HEALTH CARE TAX CREDIT

In general, to be eligible for the health care tax credit, an employer must:

- Have no more than **25 full-time equivalent employees** (FTEs);
- Pay **average annual wages of $50,000 or less** per FTE; and
- Maintain a **"qualifying arrangement."** In general, a qualifying arrangement is one where the employer pays premiums for each employee enrolled in its health insurance coverage in an amount equal to a uniform percentage of not less than 50 percent of the premium cost of the coverage. Beginning with the 2014 taxable year, a qualifying arrangement is one where the employer is required to pay a uniform percentage (not less than 50 percent) of the premium cost of a qualified health plan offered by the employer to its employees through a SHOP Exchange.

The health care tax credit will continue to be available in 2014 and later taxable years. However, a few key aspects of the tax credit change beginning in 2014. Beginning with 2014:

- The dollar amount of average annual wages is subject to a cost-of-living adjustment. On Oct. 31, 2013, the IRS announced that, for 2014, an employer must pay average annual wages of **$50,800 or less** per FTE to be eligible for the health care tax credit.
- Employers must purchase health insurance coverage through a SHOP Exchange to be eligible for the health care tax credit.
- The health care tax credit is only available to an employer for two consecutive taxable years.

In most cases, employers that are agencies or instrumentalities of the federal government, or of a state, local or Indian tribal government, are not eligible for the credit. A section 521 farmers cooperative that is subject to tax under Internal Revenue Code section 1381 is eligible to claim the small business tax credit as a taxable employer, if it otherwise meets the definition of an eligible small employer.

An employer that meets the requirements for the tax credit may claim the credit even if its employees are not performing services in a trade or business. For example, a household employer may be eligible for the health care tax credit.

In addition, for tax years 2010 through 2013, an eligible small employer (including a tax-exempt eligible small employer) that is located outside the United States may claim the tax credit only if it pays premiums for an employee's health insurance coverage that is issued in and regulated by one of the 50 states or the District of

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Columbia. Beginning with the 2014 tax year, an employer located outside of the United States must be able to offer a qualified health plan to its employees through a SHOP Exchange to be eligible for the credit.

Step One – Determine the Employees Who Are Taken Into Account

In general, employees who perform services for the employer during the taxable year are taken into account when determining if the employer is eligible for the health care tax credit. This includes former employees who terminated employment during the year, employees covered under a collective bargaining agreement and employees who did not enroll in the employer's health insurance plan.

In addition, all employees of a controlled group or an affiliated service group, including their wages and premiums, are taken into account when determining if an employer is eligible for the health care tax credit.

Leased employees are counted in determining an employer's eligibility for the tax credit. However, the premiums for health insurance coverage paid by a leasing organization for leased employees are not taken into account in calculating the amount of the credit.

In addition, a minister performing services in the exercise of his or her ministry is taken into account if he or she is an employee under the common law test for determining worker status (employee vs. self-employed). However a minister's compensation is not considered wages for purposes of computing the employer's average annual wages.

The following individuals are **not** included in this determination:

- Seasonal workers are disregarded in determining FTEs and average annual wages, unless a seasonal worker worked for the employer on more than 120 days during the taxable year. However, premiums paid on their behalf may be counted in determining the amount of the health care tax credit.
- Business owners, including a sole proprietor, a partner in a partnership, a shareholder owning more than two percent of an S corporation and any owner of more than five percent of other businesses, are not taken into account for purposes of the credit.
- Members of a business owner's family or household (including spouses) are also disregarded for purposes of the health care tax credit.

Under the final rule, a **seasonal worker** means a worker who performs labor or services on a seasonal basis, including (but not limited to):

- Workers covered by 29 CFR 500.20(s)(1). ("Labor is performed on a seasonal basis where, ordinarily, the employment pertains to or is of the kind exclusively performed at certain seasons or periods of the year and which, from its nature, may not be continuous or carried on throughout the year. A worker who moves from one seasonal activity to another, while employed in agriculture or performing agricultural labor, is employed on a seasonal basis even though he may continue to be employed during a major portion of the year."); and
- Retail workers employed exclusively during holiday seasons.

The final rule clarifies that employers may apply a reasonable, good faith interpretation of the term seasonal worker and a reasonable good faith interpretation of 29 CFR 500.20(s)(1) (including as applied by analogy to workers and employment positions not otherwise covered under 29 CFR 500.20(s)(1)).

Step Two – Determine the Hours of Service Performed by These Employees

An employee's hours of service for a year include each hour for which an employee is paid, or entitled to payment, for the performance of duties for the employer during the employer's taxable year. It also includes each hour for which an employee is paid, or entitled to payment, by the employer on account of a period of time when no duties are performed due to vacation, holiday, illness, incapacity (including disability), layoff, jury duty, military duty or leave of

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absence. No more than 160 hours of service are required to be counted for an employee during any single continuous period during which the employee does not perform any duties.

An employer may use any of the following methods to calculate employees' hours of service for the taxable year:

- Counting **actual hours** worked;
- Using a **days-worked equivalency method** where the employee is credited with eight hours of service for each day for which the employee would be required to be credited with at least one hour of service because he or she is paid or entitled to payment; or
- Using a **weeks-worked equivalency method** where the 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 because he or she is paid or entitled to payment.

An employer does not need to use the same method for all employees; different methods may be used for different classifications of employees, if the classifications are reasonable and consistently applied. For example, an employer may use the actual hours worked method for all hourly employees and the weeks-worked equivalency method for all salaried employees. In addition, employers may change the method for calculating employees' hours of service for each taxable year.

Example: For the 2014 taxable year, an employer's payroll records indicate that Employee A worked 2,000 hours and was paid for an additional 80 hours on account of vacation, holiday and illness. The employer counts hours actually worked. Under this method of counting hours, Employee A must be credited with 2,080 hours of service (2,000 hours worked and 80 hours for which payment was made or due).

Example: For the 2014 taxable year, Employee B worked 49 weeks, took two weeks of vacation with pay, and took one week of leave without pay. The employer uses the weeks-worked equivalency method. Under this method of counting hours, Employee B must be credited with 2,040 hours of service (51 weeks multiplied by 40 hours per week).

Step Three – Calculate the Number of FTEs

The number of an employer's FTEs is determined by dividing (1) the total hours of service credited during the year to employees (but not more than 2,080 hours for any employee) by (2) 2,080.

The result, if not a whole number, is rounded down to the next lowest whole number. If, after dividing the total hours of service by 2,080, the resulting number is less than one, the employer rounds up to one FTE.

Because the tax credit's eligibility formula is based in part on the number of FTEs, not the number of employees, some businesses will qualify even if they employ more than 25 individual workers. For example, an employer with 46 half-time employees (that is, employees paid for 1,040 hours) has 23 FTEs and may qualify for the tax credit.

Example: For the 2014 taxable year, an employer pays five employees wages for 2,080 hours each, three employees wages for 1,040 hours each and one employee wages for 2,300 hours. The employer does not use an equivalency method to determine hours of service for any of these employees. The employer's FTEs would be calculated as follows:

- Total hours of service not exceeding 2,080 per employee is the sum of:
    - 10,400 hours of service for the five employees paid for 2,080 hours each (5 x 2,080);
    - 3,120 hours of service for the three employees paid for 1,040 hours each (3 x 1,040); and
    - 2,080 hours of service for the one employee paid for 2,300 hours (lesser of 2,300 and 2,080).

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- The sum of the above equals 15,600 hours of service.
- FTEs equal 7 (15,600 divided by 2,080 = 7.5, rounded to the next lowest whole number).

Step Four – Calculating Average Annual Wages

An employer's average annual wages is determined by dividing (1) the total wages paid by the employer to employees by (2) the number of the employer's FTEs for the year. The result is then rounded down to the nearest $1,000 (if not otherwise a multiple of $1,000).

Only wages that are paid for hours of service are taken into account. Wages for this purpose means FICA wages, including overtime pay, determined without regard to the wage base limitation. Thus, for example, if an employee works more than 2,080 hours in a year, all wages paid to the employee, including wages for the hours in excess of 2,080, are taken into account in computing the employer's average annual wages.

Example: For the 2014 taxable year, an employer pays $224,000 in wages and has 10 FTEs. The employer's average annual wages is $22,000 ($224,000 divided by 10 = $22,400, rounded down to the nearest $1,000).

Step Five – Determining Whether Coverage Is a Qualifying Arrangement

A qualifying arrangement is one where the employer pays premiums for each employee enrolled in **health insurance coverage** offered by the employer in an amount equal to a **uniform percentage** (not less than 50 percent) of the premium cost of the coverage.

Beginning with the 2014 tax year, a qualifying arrangement is one where the employer is required to pay a uniform percentage (not less than 50 percent) of the premium cost of a qualified health plan offered by the employer to its employees through a SHOP Exchange. The final rule confirms that a stand-alone dental health plan offered through a SHOP Exchange will be considered a QHP for purposes of the credit.

Health Insurance Coverage (2010-2013 Tax Years)

Health insurance coverage for purposes of a qualifying arrangement must be offered by a health insurance issuer. Therefore, a self-insured plan is not considered to be health insurance coverage for the credit and employer contributions to self-insured plans are not qualifying arrangements. Because account-based plans are not health insurance coverage, employer contributions to HRAs, health FSAs and HSAs are also not qualifying arrangements.

In addition, for years prior to 2014, health insurance coverage for purposes of the credit means benefits consisting of medical care (provided directly, through insurance or reimbursement, or otherwise) under any hospital or medical service policy or certificate, hospital or medical service plan contract, or health maintenance organization contract offered by a health insurance issuer. It also includes:

- Limited scope dental or vision plans;
- Plans providing long-term care, nursing home care, home health care, community-based care or any combination of these types of care;
- Coverage only for a specified disease or illness;
- Hospital indemnity or other fixed indemnity insurance; and
- Medicare supplemental health insurance, certain other supplemental coverage and similar supplemental coverage provided to coverage under a group health plan.

However, health insurance coverage does **not** include certain excepted benefits, such as:

- Coverage only for accident, or disability income insurance, or a combination of the two;

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- Coverage issued as a supplement to liability insurance;
- Liability insurance, including general liability insurance and automobile liability insurance;
- Workers' compensation or similar insurance;
- Automobile medical payment insurance;
- Credit-only insurance;
- Coverage for on-site medical clinics; or
- Other similar insurance coverage, specified in regulations, under which benefits for medical care are secondary or incidental to other insurance benefits.

Different types of health insurance plans are not aggregated for purposes of meeting the qualifying arrangement. For example, if an employer offers a major medical insurance plan and a stand-alone vision plan, the employer must separately satisfy the requirements for a qualifying arrangement with respect to each type of coverage.

Contributions by an employer to a multiemployer plan that are used to pay premiums for health insurance coverage for employees are treated as payment of health insurance premiums by the employer. However, self-insured health coverage provided through a multiemployer plan is not health insurance coverage provided under a qualifying arrangement. Also, employer contributions for benefits other than health insurance are not taken into account.

Because a church welfare benefit plan is subject to state insurance law enforcement, it satisfies the requirements for health insurance coverage. Therefore, for purposes of the tax credit, an arrangement under which a small church employer pays premiums for employees who receive medical care provided though a church welfare benefit plan may be a qualifying arrangement.

Uniform Percentage Requirements

As explained above, to be eligible for the credit, an employer must pay a uniform percentage (at least 50 percent) of the premium for each employee enrolled in the employer's health insurance coverage. This rule is known as the "uniformity requirement." Beginning in 2014, the health insurance coverage must be provided through a QHP purchased on a SHOP Exchange.

The final rule explains how to apply the uniformity requirement in different situations depending upon whether:

- The QHP premium is based on list billing or composite billing;
- The QHP offers employee-only coverage, or other tiers of coverage (such as family coverage); and
- The employer offers one QHP or more than one QHP.

Composite billing means that a health insurer charges a uniform premium for each of the employer's employees or charges a single aggregate premium for the group of covered employees that the employer may divide by the number of covered employees to determine the uniform premium.

List billing, on the other hand, means that a health insurer charges a separate premium for each employee based on employee's age or other factors.

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Employers with One QHP	Employers with More than One QHP
Employers offering one QHP under a composite billing system with one level of employee-only coverage must pay the same amount for each employee enrolled in coverage that is at least 50 percent of the premium for employee-only coverage. For additional tiers of coverage under a composite billing system, employers can pay the same amount for each employee enrolled in a particular coverage tier that is equal to at least 50 percent of the premium for that coverage tier, or pay an amount for each employee enrolled in a tier of coverage other than employee-only coverage that is the same for all employees and is no less than the amount that the employer would have contributed toward employee-only coverage (and is equal to at least 50 percent of the premium for employee-only coverage). If an employer with one plan uses list billing, it must follow similar rules, although it can convert the individual premiums for employee-only coverage into an employer-computed composite rate for employee-only coverage.	When an employer offers more than one QHP to its employees through a SHOP Exchange, the uniform percentage requirement may be satisfied in one of the following two ways: *Plan-by-plan Method:* The employer's premium payments for each plan must individually satisfy the uniform percentage requirements. The amounts or percentages of premiums paid toward each QHP do not have to be the same, but they must each satisfy the uniform percentage requirement if each QHP is tested separately. *Reference Plan Method:* The employer designates one of its QHPs as a reference plan. Then, the employer: (1) determinates a level of employer contributions for each employee so that, if all eligible employees enrolled in the reference plan, the contributions would satisfy the uniform percentage requirement as applied to that reference plan; and (2) allows each employee to apply the minimum amount of employer contribution determined necessary to meet the uniform percentage requirement toward the reference plan or toward coverage under any other available QHP.

The IRS provided transition relief in applying the uniformity requirement for tax years beginning in 2010. For tax years beginning in 2010, employers could choose between the requirements described above or the IRS's transition relief. Under the transition rules, an employer is considered to satisfy the uniformity requirement if it pays an amount equal to at least 50 percent of the premium for single (employee-only) coverage for each employee enrolled in the employer's health insurance coverage, even if the employer does not pay the same percentage of the premium for each employee.

Example: For the 2010 tax year, an eligible small employer has nine FTEs with average annual wages of $23,000 per FTE. Six employees are enrolled in single coverage and three employees are enrolled in family coverage. The premiums are $8,000 for single coverage for the year and $14,000 for family coverage for the year. The employer pays 50 percent of the premium amount for single coverage ($4,000) for each employee (whether enrolled in single or family coverage). Thus, the employer pays $4,000 of the premium for each of the six employees enrolled in single coverage and $4,000 of the premium for each of the three employees enrolled in family coverage. The employer is deemed to satisfy the uniformity requirement for a qualifying arrangement under the transition relief rule.

Tobacco Surcharge and Wellness Program Incentives

Tobacco usage is an allowable rating factor in the SHOP Exchange that may affect employee premiums. The final rule provides that a tobacco surcharge applicable to SHOP Exchange coverage and amounts paid by the employer to cover the surcharge are not included in premiums for purposes of calculating the uniform percentage requirement, and payments of the surcharge are not treated as premium payments for purposes of the credit. The final rule also

provides that the uniform percentage requirement is applied without regard to employee payment of the tobacco surcharges in cases in which all or part of the employee tobacco surcharges are not paid by the employer.

In addition, the final rule provides that any additional amount of employer contribution attributable to an employee's participation in a wellness program (as compared to the employer contribution with respect to an employee that does not participate in the wellness program) is not taken into account in calculating the uniform percentage requirement. This rule applies whether the difference is due to a discount for participation or a surcharge for nonparticipation. The employer contributions for employees who do not participate in the wellness program must be at least 50 percent of the premium (including any premium surcharge for nonparticipation). However, for purposes of computing the credit, the employer contributions are taken into account, including those contributions attributable to an employee's participation in a wellness program.

State or Local Law Compliance

State or local laws may require employers to contribute certain amounts toward employees' premium costs. At least one state (Hawaii) requires employers to contribute a certain percentage (for example, 50 percent) to an employee's premium cost, but also requires that the employee's contribution not exceed a certain percentage of monthly gross earnings. The final rule provides that an employer will be treated as meeting the uniform percentage requirement if the failure to satisfy the requirement is attributable to additional employer contributions made to certain employees solely to comply with an applicable state or local law.

In addition, the proposed rule recognizes that state or local laws may require employers to contribute certain amounts toward employees' premium costs. The proposed rule provides that an employer will be treated as meeting the uniform percentage requirement if the failure to satisfy the requirement is attributable to additional employer contributions made to certain employees solely to comply with an applicable state or local law.

TRANSITION RULE FOR 2014

The IRS recognizes that, if an eligible small employer's plan year begins on a date other than the first day of its taxable year, it may not be possible or practical for the employer to offer insurance to its employees through a SHOP Exchange at the beginning of its first taxable year beginning in 2014. The final rule provides a transition rule for an employer that:

- As of Aug. 26, 2013, offers coverage in a plan year that begins on a date other than the first day of its taxable year;
- Offers coverage during the period before the first day of the plan year beginning in 2014 that would have qualified the employer for the health care tax credit under the rules that apply to periods before Jan. 1, 2014; and
- Begins offering coverage through a SHOP Exchange as of the first day of the plan year that begins in 2014.

Small employers that satisfy the criteria for the transition rule will be treated as offering coverage through a SHOP Exchange for their entire 2014 taxable year for purposes of determining eligibility for the health care tax credit and calculating the credit. Thus, for an employer that qualifies for the transition relief, the credit will be calculated at the 50 percent rate (35 percent rate for tax-exempt eligible small employers) for the entire 2014 taxable year and the 2014 taxable year will be the start of the two-year credit period.

Also, on Jan. 6, 2014, the IRS issued Notice 2014-6 to provide transition relief for certain small employers that cannot offer a QHP through a SHOP Exchange because the employer's principal business address is in an identified county in which a QHP will not be available through a SHOP Exchange for 2014. With respect to the transition relief, the final rule clarifies that an employer with a principal business address in one of the counties listed in Notice 2014–6 is not required to begin offering coverage through a SHOP Exchange as of the first day of its plan year that begins in 2014 in order to be treated as offering coverage through a SHOP Exchange for its entire 2014 year. Instead, the

employer is required to continue offering health insurance coverage for the plan year that begins in 2014 that would have qualified for a tax credit under the rules applicable before 2014.

EFFECT OF SEQUESTER

As a result of the sequester, the IRS announced that there will be a **7.2 percent reduction** of the refund payments issued to certain small tax-exempt employers claiming the refundable portion of the small employer tax credit. According to the IRS, the sequestration reduction rate will be applied to refund payments processed between Oct. 1, 2013, and Sept. 30, 2014, unless and until a law is enacted that cancels or otherwise impacts the sequester, at which time the sequestration reduction rate is subject to change. Affected taxpayers will be notified through correspondence that a portion of their requested payment was subject to the sequester reduction and the amount.

MORE INFORMATION

Please contact Clark-Mortenson Insurance for more information on the health care tax credit, including calculating and claiming the credit. Also, more information about the tax credit, including tax tips, guides and answers to frequently asked questions, is available on the IRS website.

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