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Small Employers Eligible for the 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 with the 2010 tax year. 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. This ACA Overview describes the employers eligible for the ACA's health care tax credit.

LINKS AND RESOURCES

- IRS Q&As on the small employer health care tax credit are available on the IRS website
- Additional guidance is available in Notices 2010-44 and 2010-82, and on the IRS's Small Business Health Care Tax Credit webpage
- On June 30, 2014, the IRS issued a final rule on the ACA's small employer health care tax credit. This rule finalized a proposed rule from Aug. 23, 2013, with only a few changes and clarifications. The final rule applies for taxable years beginning after 2013, though employers could rely on the proposed rule for taxable years beginning after 2013 and before 2015.
- A Small Business Health Care Tax Credit Estimator and an FTE Calculator are available on HealthCare.gov

HIGHLIGHTS

ELIGIBLE EMPLOYERS

To be eligible, an employer must:

- Have fewer than **25 full-time equivalent employees** (FTEs);
- Pay **average annual wages of less than $51,800 for 2016** per FTE; and
- Pay **at least half** of employee health insurance premiums.

CHANGES FOR 2014

Although the credit is available after 2014, a few key changes apply.

- Employers must purchase coverage for their employees through a SHOP Exchange to be eligible;
- The maximum credit increased to 50 percent of premiums paid (35 percent for tax-exempt small employers); and

An employer may only claim the credit for two consecutive tax years.

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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 to their employees.

- For 2010 through 2013, the maximum health care tax credit was **35 percent** of premiums for small business employers and **25 percent** of premiums for small tax-exempt employers.
- For 2014 and later tax years, the maximum credit was increased to **50 percent** for small business employers, and **35 percent** for small tax-exempt employers.

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; $25,800 or less for 2015; $25,900 or less for 2016; $26,200 or less for 2017). Eligible small employers with more FTEs or higher average annual wages than these thresholds receive a reduced tax credit.

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.

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. Prior to 2014, the amount of an employer's premium payments that counted for purposes of the credit was 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 was substituted for the actual premium.

> **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 file an **IRS Form 990-T** to claim the 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.

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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 FTEs**;
- Pay **average annual wages of $50,000** (as adjusted) 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.

These key aspects of the tax credit changed beginning with the 2014 tax year:

- The initial dollar limit on average annual wages of $50,000 is subject to a cost-of-living adjustment, as follows: $50,800 for 2014; $51,600 for 2015; $51,800 for 2016; $52,400 for 2017.
- Employers must purchase qualified health plan (QHP) 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 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 was located outside of the United States could 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 Columbia. Beginning with the 2014 tax year, an employer located outside of the U.S. must be able to offer a QHP 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

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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 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.

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 calculating the employer's average annual wages.

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

- Seasonal workers, 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 sole proprietors, partners in a partnership, shareholders owning more than 2 percent of an S corporation and owners of more than 5 percent of other businesses); and
- Members of a business owner's family or household (including spouses).

For this purpose, 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.

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; and

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- 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 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 1: For the 2017 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, 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 2: For the 2017 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, 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 the **total hours of service credited during the year to employees** (but not more than 2,080 hours for any employee) by **2,080**. The result, if not a whole number, is rounded down to the next lowest whole number. If the resulting number is less than one, the employer rounds up to one FTE.

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Because the tax credit's eligibility formula is based in part on the number of FTEs, and 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 2017 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 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).
- 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 the **total wages paid by the employer to employees** by 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. For this purpose, "wages" 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 2017 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

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 QHP offered by the employer to its employees through a SHOP Exchange. A stand-alone dental health plan offered through a SHOP Exchange will be considered a QHP for purposes of the credit.

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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 uniformity requirement applies differently 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 employee, 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.

EMPLOYERS WITH 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 (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 (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.

EMPLOYERS WITH MORE THAN ONE QHP

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 requirement. The amounts or percentages of premiums paid toward each QHP do not have to be the same, but must each satisfy the uniform percentage requirement if each is tested separately.

Reference Plan Method: The employer designates one QHP as a reference plan, and then: (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.

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Tobacco Surcharge and Wellness Program Incentives

Tobacco usage is an allowable rating factor in the SHOP Exchange that may affect employee premiums. 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. In addition, 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.

Any additional amount of employer contribution attributable to an employee's participation in a wellness program (as compared to the employer contribution for 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 non-participation. 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 non-participation). 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. In this case, 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.

MORE INFORMATION

Please contact Hickok & Boardman HR Intelligence 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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