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Calculating & Claiming the Small Employer Health Care Tax Credit

The Affordable Care Act (ACA) added Section 45R to the Internal Revenue Code to create a tax credit for eligible small employers that provide health insurance coverage to their employees. The tax credit became effective with tax years beginning in 2010. Both taxable and tax-exempt small employers may be eligible for the health care tax credit.

To be eligible for the health care tax credit, an employer must:

- **Have fewer than 25 full-time equivalent employees (FTEs);**
- **Pay average annual wages of less than $50,000 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 tax year, employers must purchase health insurance coverage for their employees through an Exchange's Small Business Health Options Program (SHOP) to be eligible for the tax credit.

Also, for tax years beginning with 2014, the dollar amount of average annual wages is subject to a cost-of-living adjustment. 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. For 2015, an employer must pay average annual wages of $51,600 or less per FTE to be eligible for the health care tax credit.

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.

This Legislative Brief explains how eligible small employers should calculate and claim the tax credit. Contact Power Kunkle Benefits Consulting for more information on determining eligibility for the tax credit.

CALCULATING THE CREDIT

The IRS has described specific steps for calculating the amount of the tax credit. Both small businesses and tax-exempt organizations use the IRS Form 8941 to calculate the credit. The IRS Form 8941 and related instructions are available through the IRS website.

Step 1: Calculate the Maximum Amount of the Credit

General Rules

For taxable years beginning in 2010 through 2013, the maximum credit for a taxable small employer was 35 percent of the premium payments taken into account. For a tax-exempt small employer for those years, the maximum credit was 25 percent of premium payments.

For 2014 tax years and later, the maximum health care tax credit increased 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 a SHOP Exchange.

For tax years 2010 through 2013, only premiums paid to a health insurance issuer, such as an insurance company or HMO, count for purposes of the credit. Premiums for insurance that covers a wide variety of conditions, such as a major medical plan, and premiums for coverage that is more limited in scope, such as dental or vision, also count. Beginning with the 2014 tax year, only premiums paid for a qualified health plan (QHP) purchased through a SHOP Exchange count for purposes of the credit.

Employer contributions to health reimbursement arrangements (HRAs), health flexible spending accounts (FSAs) and health savings accounts (HSAs) are not taken into account for purposes of the credit. However, a stand-alone dental health plan offered through a SHOP Exchange is considered a QHP for purposes of the 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.

Applicable Limits

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 counts 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. The cap that was used for each employee depended on the coverage the employee had. If an employer had employees in multiple states, the employer would apply the average state premium for each employee based on the state where the employee worked.

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).

For a tax-exempt employer, there is an additional cap on the amount of the credit. It cannot exceed the total amount of income tax and Medicare tax that the employer is required to withhold from employees' wages for the year.

Step 2: Reduce the Maximum Credit under the Phase-out Rule

The tax credit is gradually phased out for small employers with more than 10 FTEs or average annual wages in excess of $25,000 (the dollar amount was increased for inflation to $25,400 for 2014 and $25,800 for 2015).

The following rules apply to the phase-out calculation:

- **If the number of FTEs exceeds 10, the reduction is determined by multiplying the otherwise applicable credit amount by a fraction. The numerator of the fraction is the number of FTEs in excess of 10 and the denominator is 15.**
- **If average annual wages exceed $25,000 in 2010-2013 (or $25,400 in 2014 and $25,800 for 2015), the reduction is determined by multiplying the otherwise applicable credit amount by a fraction. The numerator of this fraction is the amount by which average annual wages exceed $25,000 (or $25,400, in 2014 and $25,800 for 2015) and the denominator is $25,000 (or $25,400, in 2014 and $25,800 for 2015).**

In both cases, the result of the calculation is subtracted from the otherwise applicable credit to determine the employer's actual credit.

For an employer with both more than 10 FTEs and average annual wages exceeding $25,000 (or $25,400, in 2014 and $25,800 for 2015), the total reduction is the sum of the two reductions. This may reduce the credit to zero for some employers with fewer than 25 FTEs and average annual wages of less than $50,000 (or $50,800, in 2014 and $51,600 in 2015).

Example: For the 2013 taxable year, a taxable small employer has 12 FTEs and average annual wages of $30,000. The employer pays $96,000 in health insurance premiums for its employees (which does not exceed the average premium for the small group market in the employer's state) and otherwise meets the requirements for the credit.

- The maximum amount of the credit determined before any reduction is $33,600 (35% x $96,000).
- The credit reduction for FTEs in excess of 10 is equal to $4,480 ($33,600 x 2/15). The credit reduction for average annual wages in excess of $25,000 is equal to $6,720 ($33,600 x $5,000/$25,000). The total credit reduction is equal to $11,200 ($4,480 + $6,720).
- The total 2012 tax credit equals $22,400 ($33,600 – $11,200).

Step 3: For Employers Receiving a State Credit or Subsidy for Health Insurance, Determine the Employer's Actual Premium Payment

Some states offer tax credits or a premium subsidy to certain small employers who provide health insurance to their employees. Generally, the premium subsidy is in the form of direct payments to the employer or to the employer's insurance company. The effect these credits and subsidies have on an employer's federal health care tax credit depends on whether the direct payment goes to the employer or the insurance company.

If a state tax credit or a premium subsidy is paid directly to the employer, the effect on calculation of the federal health care tax credit in general is zero. If a state makes payments directly to an insurance company, the state is treated as making these payments on behalf of the employer.

A state-administered program (such as Medicaid) may make payments directly to a health care provider or insurance company on behalf of eligible individuals and their families. Those payments are not taken into account in determining the employer's federal health care tax credit.

Example: Employer's state provides a health insurance premium subsidy of up to 40 percent of the health insurance premiums for each eligible employee. The state pays the subsidy directly to Employer. Employer has one employee, Employee D. Employee D's health insurance premiums are $100 per month and are paid as follows: $80 by the employer and $20 by Employee D through salary reductions to a cafeteria plan. The state pays Employer $40 per month as a subsidy for Employer's payment of insurance premiums on behalf of Employee D. Employer is otherwise an eligible small employer that meets the requirements for the health care tax credit. For purposes of the requirements for a qualifying arrangement, and for purposes of calculating the amount of the tax credit, the amount of premiums paid by the employer is $80 per month (the premium payment by the Employer without regard to the subsidy from the state).

Example: Employer's state provides a health insurance premium subsidy of up to 50 percent for each eligible employee. The state pays the premium directly to the employer's health insurance provider. Employer has one employee, Employee E. Employee E is enrolled in single coverage under Employer's health insurance plan. Employee E's health insurance premiums are $100 per month and are paid as follows: $30 by the employer; $50 by the state and $20 by the employee. The state pays the $50 per month directly to the insurance company and the insurance company bills the employer for the employer and employee's share, which equal $50 per month. Employer is otherwise an eligible small employer that meets the requirements for the health care tax credit. For purposes of the requirements for a qualifying arrangement, and for purposes of calculating the amount of the health care tax credit, the amount of premiums paid by the employer is $80 per month (the sum of the employer's payment and the state's payment).

Example: Employer's state provides a health insurance premium subsidy of up to 50 percent for each eligible employee. The state pays the premium directly to the employer's health insurance provider. Employer has one employee, Employee F. Employee F is enrolled in single coverage under Employer's health insurance plan. Employee F's health insurance premiums are $100 per month and are paid as follows: $20 by the employer; $50 by the state and $30 by the employee. The state pays the $50 per month directly to the insurance company and the insurance company bills the employer for the employer's and employee's shares, which total $50 per month. Employer is otherwise an eligible small employer that meets the requirements for the health care tax credit. The amount of premiums paid by the employer for purposes of determining whether the employer meets the qualifying arrangement requirement (the sum of the employer's payment and the state's payment) is $70 per month, which is more than 50 percent of the $100 monthly premium payment. The amount of the premium for calculating the maximum Code section health care tax credit is also $70 per month. The maximum credit is $24.50 ($70 x 35%).

The employer's net premium payment is $20 (the amount actually paid by the employer excluding the state subsidy). After applying the limit for the employer's net premium payment, the health care tax credit is $20 per month, (the lesser of $24.50 or $20).

CLAIMING THE CREDIT

The health care tax credit is claimed on an eligible small business's annual income tax return. Tax-exempt organizations claim the health care tax credit on an IRS Form 990-T. In both cases, employers must attach an IRS Form 8941, showing the calculation of the claimed credit.

For a small business, the credit is a general business credit that offsets the employer's actual tax liability for the year. Any unused credit amount can be carried back one year and carried forward 20 years. (However, because an unused credit amount cannot be carried back to a year before the effective date of the credit, any unused credit amounts for taxable years beginning in 2010 could only be carried forward.)

For a tax-exempt small employer, the credit is a refundable credit, so that even if the employer has no taxable income, the employer may receive a refund, as long as it does not exceed the tax-exempt employer's total income tax withholding and Medicare tax liability for the year.

The credit can be reflected in determining estimated tax payments for the year in which the credit applies, in accordance with regular estimated tax rules. The credit can also be used to offset an employer's alternative minimum tax (AMT) liability for the year, subject to certain limitations. However, because the credit applies against income tax, an employer may not reduce employment tax deposits and payments during the year in anticipation of the credit. Finally, employers cannot deduct the portion of the health insurance premiums which is equal to the amount of the health care tax credit.

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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 provided a transition rule for an employer that:

- **As of Aug. 26, 2013, offered coverage in a plan year that begins on a date other than the first day of its taxable year;**
- **Offered 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 applied to periods before Jan. 1, 2014; and**
- **Began 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 clarified that an employer with a principal business address in one of the counties listed in Notice 2014–6 was not required to begin offering coverage through a SHOP Exchange as of the first day of its plan year that began in 2014 in order to be treated as offering coverage through a SHOP Exchange for its entire 2014 year. Instead, the employer was required to continue offering health insurance coverage for the plan year that began 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

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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