The Small Business Health Care Tax Credit Kit

This content provides practical information concerning the Small Business Health Care Tax Credit and is provided with the understanding that ADP is not rendering tax advice or legal advice. You should consult with a professional tax advisor for tax advice and any specific questions about your eligibility for the Small Business Health Care Tax Credit. You assume all responsibility for and risk arising from your use of and reliance upon the contents of this guide.

About the Small Business Health Care Tax Credit Kit

This Kit is designed to assist small employers in understanding the Small Business Health Care Tax Credit, which is available to certain employers that pay at least 50% of their employees' health care premiums. To be eligible, an employer must: (1) pay a uniform percentage (at least 50%) of the health insurance premiums for each employee enrolled in group health coverage; and (2) have less than 25 full-time equivalent employees (FTEs) with average annual wages of less than $50,800 per FTE (for the 2014 tax year; $50,000 for previous tax years).

The Internal Revenue Service (IRS) issued extensive guidance pertaining to the credit and the eligibility requirements. This Kit consolidates the information provided by the IRS and provides additional information on the practical implications of the health care tax credit for small employers.

This Kit includes:

- A how-to guide for determining eligibility, calculating and claiming the tax credit
- Government forms& fact sheets*:
    1. Small Business Health Care Tax Credit Fact Sheet
    2. Frequently Asked Questions
    3. Small Business Health Care Tax Credit Scenarios
    4. 3 Simple Steps to Determining Eligibility
- Support for your health care tax credit related questions. Questions relating to the small business health care tax credit or the Health Care Tax Credit Assist product should be directed to your Payroll Support Center. The number for your Payroll Support Center can be found by clicking on the "Support Center" icon located at the top of your RUN Powered by ADP® account.

** See the IRS website for current copies of Forms 8941 and 990-T. Form 8941, which can be used to determine the amount of the credit, can be found by clicking here. Form 990-T, which can be used by tax exempt organizations to request a credit for health insurance premiums paid, can be found by clicking here.*

How to use this Kit

How-to Guide and Forms

The remaining pages of this document include the *Step-by-Step Guide for Understanding the Small Business Health Care Tax Credit* as well as related forms and documents. You can use the bookmarks on the left side of the page to navigate to specific sections of the Kit.

Phone Support

For questions relating to the small business health care tax credit or the Health Care Tax Credit Assist product, please call your Payroll Support Center. The number for your Payroll Support Center can be found by clicking on the "Support Center" icon located at the top of your RUN Powered by ADP® account.

A Step-by-Step Guide to Understanding the Small Business Health Care Tax Credit

Table of Contents

Overview

In March 2010, President Obama signed into law the Patient Protection and Affordable Care Act (Pub. L. No. 111-148) and the Health Care and Education Affordability Reconciliation Act (Pub. L. No. 111-152). Collectively, the two laws are referred to as the "ACA" or "health care reform."

Among other things included in the health care reform legislation is a small business health care tax credit. The tax credit is designed to encourage small employers to offer, and maintain, group health insurance.

The credit is available to certain small employers that pay a uniform percentage that is at least half the cost of health coverage for their employees. In addition, the employer must have fewer than 25 full-time equivalent employees (FTEs) for the taxable year with average annual wages of less than $50,800 per FTE (for the 2014 tax year; $50,000 for previous tax years).

For tax years 2010 through 2013, the maximum credit is 35% of an eligible employer's premium expenses. Beginning in the 2014 tax year, the maximum credit is 50%. For tax-exempt qualified employers, the maximum credit is 25% for tax years 2010 through 2013, and 35% for tax years beginning in 2014. The total credit is reduced if the number of FTEs exceeds 10, or if the average annual wages exceed $25,400 (for the 2014 tax year; $25,000 for previous tax years). See the chapter on *Maximum Credit and the Phase-out Rule* for more information.

The credit may be claimed for tax years 2010 through 2013 and for any two consecutive years after that period. If the employer pays taxes on a calendar year basis, the credit first applies for the taxable year beginning on January 1, 2010 and ending December 31, 2010. However, if the employer pays taxes on a fiscal year basis, the credit applies to the employer's fiscal year (e.g., July 1, 2010 through June 30, 2011).

On May 17, 2010, the IRS issued Notice 2010-44 ("IRS Notice 2010-44"), which provides guidance on employer eligibility for the health care tax credit. On December 2, 2010, the IRS issued Notice 2010-82, providing further clarification with regard to the small business health care tax credit. On June 26, 2014, the IRS released more guidance in TD 9672. In this Guide, we have consolidated the IRS guidance and have also provided additional information on the practical implications of the health care tax credit for small employers.

Eligibility Requirements

To be eligible for the small business health care tax credit, the following requirements must be met:

1. The employer must have fewer than 25 full-time equivalent employees (FTEs) for the taxable year (regardless of the number of employees enrolled in the group health plan);

2. The average annual wages for the taxable year must be less than $50,800 per FTE (for the 2014 tax year; $50,000 for previous tax years).; *and*

3. The employer must maintain a "qualifying arrangement." A qualifying arrangement is one in which the employer pays a uniform percentage (not less than 50%) of the health insurance premiums for each employee enrolled in coverage.

In addition, for the 2014 tax year and beyond, small employers must generally purchase health insurance through the Small Business Health Options Program (SHOP Marketplace) in order to qualify for the credit*. The SHOP allows small employers to find, compare, and purchase health plans from private insurers. Employers can locate their state's Marketplace by going to Healthcare.gov.

* If an employer's plan year is not a calendar year, the employer will be treated as offering coverage through a SHOP Marketplace for 2014 if the employer:

- Offers coverage in a plan year other than a calendar year as of August 26, 2013;
- Offers coverage during the period before the first day of the plan year beginning in 2014; and
- Begins offering coverage through a SHOP Marketplace as of the first day of its plan year that begins in 2014.

The credit will be calculated at 50 percent (35 percent for nonprofits) for the entire 2014 tax year. In addition, 2014 will be the start of the two-consecutive-year credit period.

Qualifying Arrangements

In order for an employer's premium payments to count for the purposes of the credit, they must be made under a "qualifying arrangement." A qualifying arrangement is one in which the employer pays a uniform percentage (not less than 50%) of the health insurance premiums for each employee enrolled in coverage offered by the employer. This means for each employee enrolled in the health plan, the employer must pay the same percentage towards his or her premium expenses and the percentage must be at least 50%.

Note: An employer will be treated as satisfying the uniform percentage requirement if the failure to otherwise satisfy the requirement is attributable solely to additional employer contributions made to certain employees to comply with an applicable state or local law.

Different types of health insurance plans are not aggregated for purposes of meeting the qualifying arrangement requirement. 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.

Health insurance coverage for purposes of the credit means benefits consisting of:

- Medical care under any hospital or medical service policy or certificate
- Hospital or medical service plan contract
- Health maintenance organization contract offered by a health insurance issuer
- Limited scope dental or vision
- Long-term care, nursing home care, home health care, community-based care, or any combination thereof
- Coverage only for a specified disease or illness
- Hospital indemnity or other fixed indemnity insurance
- Medicare supplemental health insurance, certain other supplemental coverage, and similar supplemental coverage provided to coverage under a group health plan.

For purposes of eligibility for the credit, health care coverage must be offered by a health insurance issuer for it to be considered a qualifying health plan. As such, self-insured plans, including Health Reimbursement Arrangements (HRAs), health Flexible Spending Accounts (FSAs), and Health Savings Accounts (HSAs), are not considered health coverage for purposes of the credit.

The IRS has adopted rules to help small employers satisfy the qualifying arrangement requirement. To further understand the rules, it's important to be familiar with the following terminology:

- Composite Billing: When 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. The employer may then divide by the number of covered employees to determine the uniform premium.

- List Billing: When a health insurer lists a separate premium for employees based on the age of the employee or other factors.

- Tiers of Coverage: Coverage under a benefits package that varies by the number of individuals covered. For example, self-only coverage, self plus one coverage, and family coverage would constitute three separate tiers of coverage.

- Employer-Computed Composite Rate: The average rate determined by adding the premium for a particular tier of coverage for all employees eligible to participate in the employer's health insurance plan - whether or not they actually receive coverage under the plan – divided by the total number of eligible employees.

Under the rules, an employer may satisfy the uniformity requirement by meeting any of the following:

1. Employers offering one plan:
    a. *Employers offering one plan (self-only coverage) with composite billing:* An employer whose health insurer uses composite billing must pay the same amount toward the premium for each employee receiving self-only coverage under the plan, as long as that amount is equal to at least 50% of the self-only premium.

    b. *Employers offering one plan (other tiers of coverage) with composite billing:* If an employer offers a tier of coverage that is more expensive than self-only coverage and it pays an amount for each employee enrolled in the more expensive tier of coverage that is the same for all employees and no less than the amount the employer would have contributed toward self-only coverage for that employee.

    c. *Employers offering one plan (self-only coverage) with list billing:* To satisfy the uniformity requirement, the employer must either: (1) pay an amount equal to a uniform percentage (not less than 50%) of the premium charged for each employee; or (2) convert the individual premiums for self-only coverage into an employer-computed composite rate for self-only coverage, and, if an employee contribution is required, each employee who receives coverage under the plan pays a uniform amount toward the self-only premium that is no more than 50% of the employer-computed composite rate for self-only coverage.

d. *Employers offering one plan (other tiers of coverage) with list billing:* If an employer offers a tier of coverage that is more expensive than self-only coverage and their health insurer uses list billing, the employer meets the uniformity requirement if the employer pays toward the premium for each employee covered under that tier of coverage an amount equal to the amount the employer would have contributed toward self-only coverage for that employee.

   See example 1 below

2. Employers offering more than one plan: If an employer offers more than one health insurance plan, the employer must satisfy the uniformity requirement by either:
   a. Satisfying the rule requirements on a plan-by-plan basis. The amounts or percentages of premium paid by the employer for each plan need not be identical, so long as the payments with respect to each plan satisfy those requirements.
   b. Designating a "reference plan" and making employer contributions in accordance with the following requirements:
      i. The employer determines a level of employer contributions for each employee such that, if all eligible employees enrolled in the reference plan, the contributions would satisfy the rule requirements.
      ii. The employer allows each employee to apply the employer-contribution amount either toward the reference plan or toward the cost of coverage under any of the other available plans.

   Note: The self-only composite rate for the reference plan must be at least 66 percent of the self-only composite rate for each non-reference plan with respect to which the employer claims the credit. For the purposes of this "anti-abuse rule," the self-only composite rate is, in the case of a plan with composite billing, the rate actually charged by the health insurance issuer for self-only coverage, and, in the case of a plan with list billing, the employer-computed composite rate for self-only coverage.

   See example 2 below

Example 1: Employer offers one health insurance plan

For the 2014 taxable year, an eligible small employer offers a health insurance plan, Plan A. Employees can elect self-only or family coverage under the plan. The premiums for Plan A are as follows:

- Self-only coverage: $5,000 per year
- Family coverage: $10,000 per year

The employer pays $3,000 (60% of the premium) toward self-only coverage and $3,000 (30% of the premium) toward family coverage. Because the employer's contribution of 60% of the premium toward self-only coverage is equal to the same dollar amount toward the premium for family coverage, the employer satisfies the uniformity requirement.

Example 2: Employer offers more than one health insurance plan

For the 2014 taxable year, an eligible small employer offers two health insurance plans, Plan A and Plan B.

The premiums for Plan A are $5,000 per year for self–only coverage and $10,000 for family coverage. The premiums for Plan B are $7,000 per year for self–only coverage and $13,000 for family coverage.

The employer pays:

- $3,000 (60% of the premium) for each employee electing self-only coverage under Plan A
- $3,000 (30%of the premium) for each employee electing family coverage Plan A
- $3,500 (50% of the premium) for each employee electing self-only coverage under Plan B
- $3,500 (27% of the premium) for each employee electing family coverage under Plan B

The employer meets the uniformity requirement on a plan-by-plan basis because the employer contributes 60% of the premiums for self-only coverage for Plan A and the same dollar amount toward the premium for family coverage under Plan A. The employer also contributes 50% of premiums for self-only coverage for Plan B and that same dollar amount toward the premium for family coverage under Plan B.

Maximum Credit and the Phase-out Rule

Beginning in the 2014 tax year, the maximum credit is 50% of an eligible employer's premium expenses. For tax years 2010 through 2013, the maximum credit is 35%. For tax-exempt qualified employers, the maximum credit is 25% for tax years 2010 through 2013, and, beginning in tax year 2014, it increases to 35%. The total credit is phased out if the number of FTEs exceeds 10 or if the average annual wages exceed $25,400 (for the 2014 tax year; $25,000 for previous tax years).

If the number of full-time equivalent employees (FTEs) exceeds 10 or if average annual wages exceed $25,400, the amount of the credit is reduced as follows:

- If the number of FTEs exceeds 10, the reduction is determined by multiplying the otherwise applicable credit amount by a fraction, the numerator of which is the number of FTEs in excess of 10 and the denominator of which is 15.
    - For example, if an eligible (not tax-exempt) employer had 12 FTEs the reduction is determined by multiplying the credit amount by 2/15.

- If average annual wages exceed $25,400, the reduction is determined by multiplying the otherwise applicable credit amount by a fraction, the numerator of which is the amount by which average annual wages exceed $25,400 and the denominator of which is $25,400.
    - For example, if an eligible (not tax-exempt) employer paid average annual wages of $30,400 the reduction is determined by multiplying the credit amount (for 2014 and beyond, it is 50%) by 5,000/25,400.

In both cases, the result of the calculation is subtracted from the otherwise applicable credit to determine the credit to which the employer is entitled. For an employer with both more than 10 FTEs and average annual wages exceeding $25,400, the reduction is the sum of the amount of the two reductions. This sum may reduce the credit to zero for some employers with fewer than 25 FTEs and average annual wages of less than $50,800.

Example:

For the 2014 tax year, a qualified employer has 12 FTEs and average annual wages of $30,400. The employer pays $96,000 in health care premiums for those employees and otherwise meets the requirements for the credit. The credit is calculated as follows:

- Initial amount of credit determined before any reduction: 50% x $96,000 = $48,000
- Credit reduction for full-time employees in excess of 10: $48,000 x 2/15 = $6,400

- Credit reduction for average annual wages in excess of $25,400: $48,000 x $5,000/$25,400 = $9,449
- Total credit reduction: $6,400 + $9,449 = $15,849
- Total 2014 tax credit: $48,000 – $15849 = $32,151

Steps for Determining Tax Credit Eligibility

When determining eligibility for the small business health care tax credit, the following steps should be taken:

1. Determine which employees to take into account for purposes of calculating the credit.
2. Determine the hours of service performed by each employee for the taxable year.
3. Determine the number of full-time equivalent employees (FTEs) for the taxable year.
4. Determine the average annual wages paid to each FTE for the taxable year.
5. Determine the premiums paid by the employer for the taxable year.

Subsequent chapters of this guide cover each step in greater detail.

Step 1: Determine Employees to Take into Account

IRS Notice 2010-44 explains which individuals are taken into account when determining the number of full-time equivalent employees (FTEs). With a few limited exceptions, all employees who perform service for the employer during the taxable year are to be considered when calculating the number of FTEs.

Exceptions:

When determining the number of FTEs, as well as the average annual wages and premiums paid on their behalf, the following individuals are excluded:

1. A sole proprietor and his or her employee-spouse
2. Partners in business and the employee-spouse of said partners
3. A shareholder owning more than 2% of an S corporation and his or her employee-spouse
4. An owner of more than 5% of other businesses and his or her employee-spouse
5. Family members of the above referenced owners and partners. A family member is defined as a: child (or a descendant of a child), sibling, step-sibling, parent, step-parent, niece, nephew, aunt, uncle, son-in-law or daughter in-law, brother-in-law or sister-in law, father-in-law or mother-in-law.
6. Any other member of the household of the above referenced owners or partners who qualifies as a dependent

Seasonal workers are also excluded when determining the number of FTEs and average annual wages *unless* the seasonal employee works for the employer more than 120 days during the taxable year. However, premiums paid on behalf of seasonal workers may be counted in determining the amount of the credit.

Step 2: Determine Hours of Service

IRS Notice 2010-44 defines hours of service and provides three options for calculating employees' hours of service for the taxable year. An employee's service for the year is used to calculate the number of full-time equivalent employees (FTEs). See the next chapter of this guide for information on calculating the number of FTEs.

An employee's hours of service for the taxable year include:

1. Each hour for which an employee is paid, or entitled to payment, for the performance of duties for the employer; and

2. Each hour an employee is paid, or entitled to payment, for vacation, holidays, illnesses, incapacity (including disability), layoff, jury duty, military duty, or leave of absence. However, no more than 160 hours of service are required to be counted for any single period during which an employee performs no duties.

Note: The maximum number of hours that may be credited per employee is 2,080.

To calculate the total hours of service, employers may use any of the following methods:

1. Record of Hours. Determine the actual hours of service from records of hours worked and hours for which payment was made or due. Note: Payment is made or due for work performed, vacation, holiday, illnesses, incapacity, layoff, jury duty, military duty, or leave of absence.

   Example: For the 2014 taxable year, an employer's payroll records indicate that John Smith worked 2,000 hours and was paid for an additional 80 hours on account of vacation, holiday and illness. John Smith must be credited with 2,080 hours of service (2,000 for the hours worked plus 80 for the hours in which payment was made or due).

2. Days-worked equivalency. Use a days-worked equivalency whereby the employee is credited with 8 hours of service for each day in which payment was made or due.

3. Weeks-worked equivalency. Use a weeks-worked equivalency whereby the employee is credited with 40 hours of service for each week in which payment was made or due.

   Example: For the 2014 taxable year, an employer's payroll records indicate that Jane Doe worked a total of 49 weeks and took two weeks of vacation. She also took one week of leave without pay. In using the weeks worked equivalency, Jane Doe must be credited

with 2,040 hours of service (51 weeks - for which payment was made or due - multiplied by 40 hours per week).

The result is used in calculating the number of FTEs for the taxable year, which is covered in the next chapter of this guide.

Step 3: Determine Number of FTEs

The results from Steps 1 and 2 are used in the calculation of the number of full-time equivalent employees (FTEs) for the taxable year. To calculate the number of FTEs, the following formula is used:

Divide the total hours of service credited during the year to employees taken into account (a maximum of 2,080 hours for each employee) by 2,080. If the result isn't a whole number, it is rounded to the next lowest whole number.
Example:

For the 2014 taxable year, an employer pays the following:

a. 5 employees for 2,080 hours of service
b. 3 employees for 1,040 hours of service
c. 1 employee for 2,300 hours of service

The total hours of service not exceeding 2,080 per employee is the sum of the hours of service worked by all of the employees outlined above, which is:

a. 5 multiplied by 2,080 = 10,400 hours
b. 3 multiplied by 1,040 = 3,120 hours
c. 1 multiplied by 2,080 = 2,080 hours (if hours of service are greater than 2,080, as is the case with this employee, multiply by 2,080)

Total sum of a, b, and c = 15,600 hours

Divide the total sum (15,600) by 2,080 to calculate the number of full-time equivalent employees: 15,600/2,080 = 7.5. Round to the next lowest whole number = 7 full-time equivalent employees.
In some cases, an employer with 25 or more employees may qualify for the credit if some of its employees work part-time. As long as the number of full-time equivalent employees is less than 25, and the employer meets other qualifying criteria, the employer may be eligible for credit.

Step 4: Determine Average Annual Wages

Once the number of full-time equivalent employees (FTEs) is calculated, next determine the average annual wages paid to FTEs for the taxable year. In doing so, the following formula is used:

Divide the total wages paid by the employer during the taxable year to employees taken into account in calculating Step 1 by the number of FTEs. The result is rounded down to the nearest $1,000.

Example:

For the 2014 taxable year an employer pays $224,000 in wages and has 10 FTEs. $224,000 divided by 10 is $22,400. Rounded down to the nearest $1,000, it is: $22,000.

To qualify for the credit, the average annual wages must be less than $50,800 per FTE, and the remaining eligibility criteria must be met.

Step 5: Determine Premiums Paid

The final step in determining eligibility for the credit is to determine the employer's portion of the premiums paid for the taxable year. Only premiums paid by the employer are taken into account.

Qualifying Arrangement:

In order for an employer's premium payments to count for purposes of the credit, they must be made under a "qualifying arrangement." A qualifying arrangement is one in which the employer pays a uniform percentage of the premium (no less than 50%) for each employee enrolled in health insurance coverage offered by the employer.

Average Premium for Small Group Market:

For purposes of calculating the credit, employer-paid premiums are capped at the average premium for the small group market in the state that the employer offers coverage. The amount that exceeds the state average is excluded from the calculation of the credit. If the employer pays a portion of the premiums, then the maximum amount that may be included in the credit calculation is limited to the same portion of the state's average premium for the small group market. For example, if an employer pays 80% of the premium (and the employee pays the other 20%), the maximum amount that may be used to calculate the credit is 80% of the state's average premium for the small group market. The Department of Health & Human Services determines the average premiums for each state. The list of average premiums for the small group market in each state for the taxable year is available on IRS Form 8941.

If an employer has employees in multiple states, the employer applies the average premium separately for each employee by using the average premium for the state in which the employee works.

Example 1: Employer's premiums do not exceed average premium for small group market

For the 2014 tax year, an eligible small employer offers a health insurance plan with single and family coverage. The employer has 9 FTEs with average annual wages less than $50,800. Four of the employees are enrolled in single coverage and 5 are enrolled in family coverage. The employer pays 50% of the premiums for all employees enrolled in both single and family coverage. The premiums equate to $4,000 per year for single coverage and $10,000 per year for family coverage, with the employer paying $2,000 and $5,000, respectively. The average premium for the small group market in the employer's state is $5,000 for single coverage and $12,000 for family

coverage. The employer's premiums don't exceed 50 percent of the state's average for the small group market.

The total premium amount paid by the employer is $33,000 (4 multiplied by $2,000 plus 5 multiplied by $5,000).

Example 2: Employer's premiums exceed average premium for small group market

For the 2014 tax year, an eligible small employer offers a health insurance plan with single and family coverage. The employer has 9 FTEs with average annual wages less than $50,800. Four of the employees are enrolled in single coverage and 5 are enrolled in family coverage. The employer pays 50% of the premiums for all employees enrolled in both single and family coverage. The premiums equate to $6,000 per year for single coverage and $14,000 per year for family coverage, with the employer paying $3,000 and $7,000, respectively. However, 50% of the average premium for the small group market in the employer's state is $2,500 for single coverage and $6,000 for family coverage.

The amount of premiums paid by the employer for purposes of calculating the credit equals $40,000 (4 x $2,500) plus (5 x $6,000), which is determined using the average premiums for the small group market in the state in which the employer offers coverage.

Multiemployer Health Plans:

Employer contributions to a multiemployer plan that are used to pay premiums for health coverage on behalf of employees covered by the multiemployer plan are treated as payment by the employer, even if the insurance premiums are paid by the plan and not directly by the employer. Further, an employer will be considered to have met the uniformity requirement if 100% of the cost of coverage for all employees covered by the plan is paid through non-elective employer contributions.

How to Calculate the Credit

To calculate the credit, the following steps are used:

1. Calculate the maximum amount of the credit (for non tax-exempt organizations it is 35% for taxable years 2010 through 2013 and 50% for taxable years beginning in 2014);

2. Reduce the maximum credit in accordance with the phase-out rule if the number of full-time equivalent employees (FTEs) exceeds 10 or if the average annual wages exceed $25,400; and

3. For employers receiving a State credit or subsidy for health insurance, determine actual premium payments.

These steps are described in more detail below:

Step 1: Calculate the Maximum Credit

For taxable years 2014 and beyond, the maximum credit is 50% of the eligible employer's premium payments that are taken into account for purposes of the credit. For a tax-exempt eligible small employer, the maximum credit is 35% for taxable years 2014 and beyond.

Step 2: Reduce the maximum credit in accordance with the phase-out rule

The credit phases out gradually for eligible employers if the number of FTEs exceeds 10 or if the average annual wages exceed $25,400.

If the number of FTEs exceeds 10 or if average annual wages exceed $25,400, the amount of the credit is reduced as follows:

- If the number of FTEs exceeds 10, the reduction is determined by multiplying the otherwise applicable credit amount by a fraction, the numerator of which is the number of FTEs in excess of 10 and the denominator of which is 15.
    - For example, if an eligible (not tax-exempt) employer had 12 FTEs the reduction is determined by multiplying the credit amount (for 2014, it is 50%) by 2/15.

- If average annual wages exceed $25,400, the reduction is determined by multiplying the otherwise applicable credit amount by a fraction, the numerator of which is the amount by which average annual wages exceed $25,400 and the denominator of which is $25,400.

- For example, if an eligible (not tax-exempt) employer paid average annual wages of $30,400 the reduction is determined by multiplying the credit amount by 5,000/25,400.

In both cases, the result of the calculation is subtracted from the otherwise applicable credit to determine the credit to which the employer is entitled. For an employer with both more than 10 FTEs and average annual wages exceeding $25,400, the reduction is the sum of the amount of the two reductions. This sum may reduce the credit to zero for some employers.

Example: For the 2014 tax year, a qualified employer has 12 FTEs with average annual wages of $30,400. The employer pays $96,000 in health care premiums for those employees and otherwise meets the requirements for the credit. The credit is calculated as follows:

- Initial amount of credit determined before any reduction: 50% x $96,000 = $48,000
- Credit reduction for full-time employees in excess of 10: $48,000 x 2/15 = $6,400
- Credit reduction for average annual wages in excess of $25,400: $48,000 x $5,000/$25,400 = $9,449
- Total credit reduction: $6,400 + $9,449 = $15,849
- Total 2014 tax credit: $48,000 – $15849 = $32,151

Step 3: Determine actual premium amount if receiving State credits or subsidies

Some states offer tax credits to certain small employers that provide health insurance. In addition, some states offer premium subsidy programs in which the state makes a payment equal to a portion of the employees' health insurance premiums under the employer-provided health insurance plan.

If the employer is entitled to a state tax credit or a premium subsidy that is paid directly to the employer, the premium payment made by the employer is not reduced by the credit or subsidy for purposes of determining whether the employer has satisfied the "qualifying arrangement" requirement (i.e., a uniform percentage not less than 50%).

Generally, if a state makes premium payments directly to an insurance company to pay a portion of the premium for coverage of an employee, the payments made by a state are treated as an employer contribution for purposes of calculating the credit. However, under no circumstances may the amount of the credit exceed the amount of the employer's net premium payments (i.e., what the employer actually paid).

Example: For the 2014 taxable year, an employer's state provides a subsidy of up to 50% for each eligible employee and pays the subsidy directly to the insurance provider. The otherwise eligible employer has one employee. The employee has single coverage with a total premium of $100 per month. The employer pays $30, the state pays $50, and the employee pays $20.

For purposes of the requirements for a qualifying arrangement, and for purposes of calculating the amount of credit, the amount of premiums paid by the employer in this example is $80 per month (the sum of the employer's payment and the state's payment).

How to Claim the Credit

The credit is a general business credit and is claimed on the eligible employer's annual income tax return. 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 can only be carried forward.

IRS From 8941 can be used by both small businesses and tax-exempt organizations to calculate the credit. A small business can then include the amount of the credit as part of the general business credit on its income tax return.

For a tax-exempt eligible small employer, the credit is a refundable credit, so that even if the employer has no taxable income, the employer may receive a refund (so long as it does not exceed the tax-exempt eligible small employer's total income tax withholding and Medicare tax liability for the year). Tax-exempt organizations will claim the credit on Line 44f of a revised Form 990-T.

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 based on the amount of an employer's regular tax liability, AMT liability and other allowable credits. See Internal Revenue Code section 38(c)(1), as modified by section 38(c)(4)(B)(vi).

Because the credit applies against income tax, an employer may not reduce employment tax (i.e., withheld income tax, social security tax under sections 3101(a) and 3111(a), and Medicare tax) deposits and payments during the year in anticipation of the credit.

Practical Implications for Small Employers

Small employers should consider a variety of factors when deciding whether to offer health insurance to their employees. Health care coverage can improve attraction and retention rates as well as employee morale. Ultimately, though, the decision most often comes down to the cost of coverage.

Compared with large employers, small employers traditionally have had a smaller risk pool, less negotiating power, and higher administrative costs, so they usually end up paying higher premiums and getting less value for their health care expenditures. The health care reform legislation has several provisions aimed at making health care coverage more affordable for small employers, one of which is the small business tax credit. According to a whitehouse.gov fact sheet, an estimated 4 million small businesses may qualify for the credit, saving small employers about $40 billion by 2019. The fact sheet is available here on the Whitehouse.gov website.

Small employers that already offer health coverage should follow the steps identified in this guide to determine whether they are eligible for the tax credit. This will require keeping detailed payroll and health insurance records. Those that offer coverage, but not at a uniform percentage of at least 50%, should consider whether increasing their share of the premiums is feasible.

Another factor to consider is that for the 2014 tax year and beyond, small employers must purchase health insurance through the Small Business Health Options Program (SHOP Marketplace) in their state in order to qualify for the credit. Proponents of argue that small employers' premiums will be lower as a result of the SHOP Marketplace and other reforms. The Congressional Budget Office (CBO) has estimated the cost of premiums in the new system as compared to what they would have been under the old system. The CBO estimates that, in 2016, a family policy for small employers will be available in the SHOP Marketplace at a premium that is $4,000 lower than what would have been available under the old system.

Small employers thinking about offering health insurance coverage now have another incentive to take the plunge. The tax credit will be enough for some employers to start offering health coverage, while it may be not enough for others. Employers should weigh the benefits, incentives, risks, and costs of providing (or not providing) coverage.

Small Business Health Care Tax Credit Related Forms & Documents