The Small Business Health Care Tax Credit

Introduction

The Patient Protection and Affordable Care Act (PPACA) established a small business health care tax credit (Tax Credit) as an incentive for small employers to provide health insurance coverage to their employees. As written, PPACA limited the Tax Credit to costs relating to "health insurance coverage." Thus, it was initially unclear as to whether small employers that participated in self-funded church plans were eligible for the Tax Credit. However, recently the Internal Revenue Service (IRS) issued guidance that specifically provides local churches and small employers can qualify for the Tax Credit even if they obtain coverage through their denomination's self-funded health care plan.

Eligibility for the Tax Credit

To be eligible for the Tax Credit, there are three basic requirements:

1. The employer must have fewer than 25 full-time equivalent employees (FTEEs).
2. The average employee wages must be less than $50,000. (Note: For purposes of this requirement, the wages paid to clergy are not counted if the clergyperson does not have FICA wages).
3. The employer must pay a uniform percentage for all employees receiving coverage, and this percentage must be at least 50% of the total premium cost of single (employee-only) coverage. (Note: There is a transition rule for 2010 that is discussed below.)

Amount of Tax Credit

The Tax Credit is available beginning in 2010. For tax-exempt organizations, the Tax Credit can equal to 25% of premiums that the employer pays for health care coverage under the denominational plan. Beginning in 2014, the maximum tax credit will increase to 35% of premiums paid by eligible tax-exempt organizations—but only for coverage obtained through the yet-to-be-created health insurance exchanges. Thus, as it currently stands, after 2013, the Tax Credit will no longer be available to tax-exempt employers in self-insured church plans.

How the Tax Credit Works

The amount of the Tax Credit available for churches and other tax-exempt employers for 2010 through 2013 is equal to 25% of the lesser of the following two amounts:

1. *Actual Costs*: the total amount the employer contributes (not counting employee contributions) for coverage under the denominational health care plan, or
2. *Maximum Costs*: the total amount the employer would have paid if each employee taken into account were covered by a policy with a premium equal to the average premium for the small group market in the state. This limits the value of the Tax Credit the value of the credit for higher cost plans. (A list of the average premiums for each state is included in the instructions to IRS *Form 8941*.)

Tax-exempt employers must apply the Tax Credit as a refundable credit against certain payroll tax obligations, namely withholding of employee portions of Medicare taxes and federal income taxes, as well as the employer's share of Medicare tax obligations. That means that the amount of the Tax Credit is limited to the total of (1) the federal income tax withholding and Medicare tax withheld from employees' wages for the year, and (2) the employer's share of Medicare tax on employees' wages for the year.

Note: To the extent that a church's only employee is a clergyperson and there is no federal income tax withholding on that clergyperson's wages (as is permitted by law), the church will need to ask the clergyperson to allow the church to withhold federal income taxes from his/her compensation so that the church can take full advantage of the Tax Credit.

Credit Prorated

The Tax Credit is prorated based on the number of FTEEs and the average wages. The full amount of the Tax Credit is available only to an employer with 10 or fewer FTEEs and whose employees have average wages less than $25,000. The amount of the Tax Credit is phased-out as the number of FTEEs and average wages increase. No Tax Credit is available for employers with more than 25 FTEEs or whose average wages exceed $50,000. See *Appendix A* for a chart that illustrates this phase out.

Full-Time Employees and Average Wages

An employer calculates its number of FTEEs by adding up the total hours worked by all employees during the year (including employees who terminated employment during the year and employees who are not covered under the health care plan). For this purpose, the maximum number of hours that are counted for any single employee is 2,080. The number of total hours is then divided by 2,080. If the result not a whole number, it is rounded down to the nearest whole number. Employers may apply different methods of calculating employees' hours of service for different classifications of employees, as long as the classifications are reasonable and consistently applied. Seasonal workers are not taken into account in determining FTEEs or average wages (unless the worker works for the employer on more than 120 days during the tax year).

An employer calculates average wages by adding up the FICA wages for all employees (again, including employees who terminated employment during the year and employees who are not covered under the health care plan). The amount of total wages is then divided by the number of FTEEs. If this amount is not a multiple of 1,000, it is rounded down to the nearest $1,000.

Special Rules for Clergy. Although clergy are generally considered self-employed for Social Security (FICA) and Medicare tax purposes, most churches report the clergyperson's wages on Form W-2. Therefore, the clergyperson is considered an employee for purposes of counting the number of FTEEs. However, because clergy do not receive FICA wages and instead are taxed under SECA, their wages are not included in the average wage calculation.

Employer Contribution to Health Care Coverage

The employer must make an employer contribution on behalf of each employee who is enrolled in health care coverage. This contribution cannot be less than 50% of the premium cost of single (employee-only) coverage under the denominational plan. If an employee is receiving coverage that is more expensive than single coverage (e.g., family coverage), the employer need only pay at least 50% of the premium for single coverage for that employee (even if it is less than 50% of the premium for the coverage the employee is actually receiving).

The employer's contribution must also be a uniform percentage of the premium cost for all covered employees. In order to satisfy the uniformity requirement, the church must pay the same percentage of the premium cost for all covered employees (including the clergyperson) and that percentage must be at least 50% of the premium for employee-only coverage.

Special Transition Rule for 2010. There is a special transition rule that applies only for 2010. This rule provides that employers who pay at least 50% of the premium for each employee enrolled in coverage are eligible to receive the Tax Credit, even if they do not pay a uniform percentage of the premium for each covered employee. For example, a church that pays 75% of the premium for the minister and 50% of the premium for all other employees enrolled in the health plan will be deemed to satisfy the uniformity requirement in 2010 but would not satisfy the uniformity requirement in 2011 through 2013.

Employers Participating in Multiple Health Care Plans

Employers that offer more than one health care plan can satisfy the uniformity requirement on a plan by plan basis. That is, a church could have one health care plan for clergy and a different one for lay employees. If the church satisfies the uniformity requirement for the clergy plan, then the church can apply for the Tax Credit with respect to the clergy coverage, whether or not the lay plan satisfies the uniformity requirement. If the church also satisfies the uniformity requirement with respect to the lay plan, then the church can apply for the Tax Credit with respect to both plans, even if the percentages of premiums paid for each plan are not identical.

Claiming the Credit

Eligible tax-exempt organizations should use *Form 8941* to calculate their refundable Tax Credit, and then claim the Tax Credit on Line 44f of *Form 990-T*. Employers wishing to claim the Tax Credit for 2010 must submit a *Form 990-T* by no later than May 15, 2011.

Additional Information

For additional information about the Tax Credit, visit the IRS's website at http://www.irs.gov/newsroom/article/0,,id=231928,00.html. A detailed discussion of how to calculate the Tax Credit is included in the instructions to Form 8941, which can be found at http://www.irs.gov/pub/irs-pdf/i8941.pdf

Examples

Example 1 (Basic Calculation): A church has 5 employees: 1 clergyperson, 4 lay employees (2 who work full-time and 2 who work part-time). The clergyperson and the full-time employees each work 2,000 hours/year, while the 2 part-time employees each work 1,500 hours/year. The staff is paid as follows: $60,000 for the clergyperson; $35,000 for Employee 1; $25,000 for Employee 2; and $12,500 for each part-time employee. All wages, including those paid to the clergyperson are W-2 wages. The church has enrolled its clergyperson and the 2 full-time employees in its denominational church health plan. The cost of single employee-only health care coverage is $5,000 (which is less than the state average premium) and the church pays 75% of this premium on behalf of each covered employee ($3,750 for each employee).

STEP ONE: Calculate the FTEEs for the church by adding up the hours each employee (including the clergyperson) worked during the year and dividing by 2,080 and then rounding that amount down to the next whole number:

2,000 (clergy) + 2,000 (EE 1) + 2,000 (EE 2) + 1,500 (EE 3) + 1,500 (EE 4) = 9,000 total hours

9,000 ÷ 2,080 = **4.3**

Total number of FTEEs = 4 (4.3 rounded down to next whole number)

STEP TWO: Calculate the average wages by adding the wages of all FICA employees and dividing by the number of FTEEs (as determined under STEP ONE). Then round down to the nearest 1,000. **Note**: Although the clergyperson's hours are counted for purposes of determining FTEEs in STEP ONE, his wages are not counted for purposes of determining average wages in STEP TWO because he has no FICA wages.

$35,000 (EE 1) + $25,000 (EE 2) + $12,500 (EE 3) + $12,500 (EE 4) = $85,000 total wages

$85,000 (total wages) ÷ 4 (number of FTEEs) = $21,250

Average wages = $21,000

STEP THREE: Calculate amount of Tax Credit.

Because this church has fewer than 10 FTEEs and average wages are under $25,000, the church is eligible for the full Tax Credit of 25%.

Employer Cost = $3,750 *x* 3 (covered employees) = $11,250

Tax Credit = 25% *x* $11,250 (Employer Cost) = $2,812.50

Note: The amount of the Tax Credit cannot exceed the total amount of income and Medicare tax the church is required to withhold from employees' wages for the year and the church's share of Medicare tax on employees' wages for the year.

<u>Example 2</u> (Denominational Plan Premium is Greater Than State Average for Small Group Market): Same facts as Example 1 except that the church is located in Alabama. According to the Instructions to Form 8941, the state average premiums for small group markets in Alabama is $4,441, which is less than $5,000 (the cost of single employee-only coverage under the denominational health care plan). For purposes of calculating the Tax Credit, the cost of employee-only health care coverage is limited to $4,441, not $5,000.

STEP ONE and **STEP TWO** are the same as Example 1.

STEP THREE: Calculate amount of Tax Credit. The Tax Credit is limited to the amount the church would have paid if each employee taken into account were covered by a policy with a premium equal to the average premium for the small group market in the state. Because the state average premium is less than the actual cost under the denominational health plan, the church must use the state average premiums (i.e., $4,441 in this example) for purposes of determining the amount of Tax Credit. Further, because the church is contributing 75% of the cost of coverage under the denominational plan, the amount the church would have paid if the premium were equal to the state's average premium is 75% of $4,441 ($3,330.75).

Employer Cost (if cost was equal to state average premium) = 75% *x* $4,441 = $3,330.75

$3,330.75 *x* 3 (covered employees) = $ 9,992.25

Tax Credit = 25% *x* $9,992.25 (Employer Cost) = $2,498.06

<u>Note</u>: Again, the amount of the Tax Credit cannot exceed the total amount of income and Medicare tax the church is required to withhold from employees' wages for the year and the church's share of Medicare tax on employees' wages for the year.

Example 3 (Larger Church with Higher Average Wages): Under **STEP ONE**, the church determined that is has 12 FTEEs. Under **STEP TWO**, the church determined that it pays average wages of $27,000. The church has enrolled 10 employees in its denominational church health plan. The cost of single employee-only health care coverage is $5,000 (which is less than the state average premium) and the church pays 75% of this premium on behalf of each covered employee ($3,750 for each employee). The total amount of income tax and Medicare tax the church is required to withhold from employees' wages and the church's share of Medicare tax on employees' wages for the year was $6,000.

STEP THREE: Calculate amount of Tax Credit.

Because this church has more than 10 FTEEs and average wages are over $25,000, the church is not eligible for the full Tax Credit of 25%. The Tax Credit percentage must be reduced in accordance with Appendix A

Employer Cost = $3,750 *x* 10 (covered employees) = $37,500

Tax Credit Percentage under Appendix A = 17%

Tax Credit = 17% *x* 37,500 = $6,375

Total Income Tax Withholding and Medicare Taxes = $6,000

Tax Credit = $6,000

Note: Because the total amount of the federal income tax withholding and Medicare tax withheld from employees' wages for the year and the employer's share of Medicare tax on employees' wages for the year is less than the maximum amount of the Tax Credit available, the church will need to ask its clergy to allow the church to withhold federal income taxes from the clergy's compensation in order to take full advantage of the Tax Credit.

Appendix

Small Business Tax Credit, Nonprofit Firms in 2010-2013

	Average wages					
Firm size	**Up to $25,000**	**$30,000**	**$35,000**	**$40,000**	**$45,000**	**$50,000**
≤ 10	25%	20%	15%	10%	5%	0%
11	23%	18%	13%	8%	3%	0%
12	22%	17%	12%	7%	2%	0%
13	20%	15%	10%	5%	0%	0%
14	18%	13%	8%	3%	0%	0%
15	17%	12%	7%	2%	0%	0%
16	15%	10%	5%	0%	0%	0%
17	13%	8%	3%	0%	0%	0%
18	12%	7%	2%	0%	0%	0%
19	10%	5%	0%	0%	0%	0%
20	8%	3%	0%	0%	0%	0%
21	7%	2%	0%	0%	0%	0%
22	5%	0%	0%	0%	0%	0%
23	3%	0%	0%	0%	0%	0%
24	2%	0%	0%	0%	0%	0%
25	0%	0%	0%	0%	0%	0%