The following information is provided by The Small Business Majority Organization and is a guide to the Healthcare Reform Small Business Tax Credit. This is not tax advice and you should consult your CPA for additional information.

QUALIFYING REQUIREMENTS FOR THE TAX CREDIT

Who is eligible for the tax credit?

Small employers that provide healthcare coverage are eligible (a "qualified employer") if:

They have fewer than 25 full-time equivalent employees (FTEs)* for the tax year

The average annual wages paid are less than $50,000** per FTE

The employer pays at least 50% of the premium cost under a "qualified arrangement"

* FTEs may be calculated in any of three ways to maximize the tax credit. See "How is the number of employees determined for eligibility?" below.

** Wage limits will be indexed to the Consumer Price Index for Urban Consumers (CPI-U) for tax years beginning in 2014.

A "qualified arrangement" means:
The employer pays 50% or more of the cost of the employee-only premium for coverage through a state-licensed company for traditional health insurance. This contribution requirement also applies to add-on coverage including vision, dental and other limited-scope coverage.

CALCULATING NUMBER OF EMPLOYEES, AVERAGE ANNUAL WAGES

How is the number of employees determined for eligibility?

Only employers with fewer than 25 FTEs are eligible for the tax credit; the full credit goes to employers with 10 or fewer full-time equivalent employees (FTEs).

Employers may choose to count hours in one of three different ways, to maximize the credit and minimize their bookkeeping burden. These include:

Actual hours of service: Divide the total hours for which the employer pays wages to the employees during a taxable year by 2,080. No more than 2,080 hours (equivalent to a 40-hour work week) should be counted for any employee.

Estimate hours based on total days or service

Estimate hours based on total weeks of service

> **Example:** For the 2010 tax year, an employer pays 5 employees wages for 2,080 hours each, 3 employees wages for 1,040 hours each, and 1 employee wages for 2,300 hours.
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> The employer's FTEs would be calculated as follows:
> 1) Total hours (not exceeding 2,080 per employee) is the sum of:

a. 10,400 hours for the 5 employees paid for 2,080 hours each (5 X 2,080)
b. 3,120 hours for the 3 employees paid for 1,040 hours each (3 X 1,040)
c. 2,080 hours for the 1 employee paid for 2,300 hours (hours limited to 2,080)

Total: 15,600 hours

2) FTEs: 7 (15,600 divided by 2,080) = 7.5, rounded down to the next-lowest whole number).

Is a tax-exempt organization a qualified employer?

Yes. The same definition of qualified employer applies, but the amount of the tax credit is lower and special rules apply

CALCULATING THE TAX CREDIT

How much is the tax credit?

There is a sliding-scale tax credit of up to 35% of the employer's eligible premium expenses for tax years 2010–2013. Employers with 10 or fewer full-time employees, paying annual average wages of $25,000 or less, qualify for the maximum credit.

Beginning in tax year 2014, the maximum tax credit increases to 50% of premium expenses and coverage must be purchased from a state health insurance exchange. This tax credit is available for a total of any two years.

For tax-exempt employers, the same employee and wage requirements apply, but the maximum tax credit is 25% of eligible premium expenses for tax years 2010 – 2013, increasing to 35% in 2014.

The amount of the tax credit cannot exceed the total income and Medicare tax the employer is required to withhold from employees' annual wages, plus the employer's share of the Medicare tax.

What expenses are counted in calculating the credit?

Only the employer contribution to the premium amount counts as an eligible expense, subject to the limit described below. If an employer pays 80% of the premium, then 80% of the premium expense is counted. The premium contribution counted includes traditional health insurance, vision, dental and other limited-scope coverage.

An employer's eligible premium contribution is capped at the average cost of health insurance for the small group market in their state (or an area of the state). If an employer pays 80% of the premium, then the amount that counts is limited to the same portion—80% of the average cost of health insurance in the state. This provision is designed to avoid an incentive to choose a high-cost plan.

Any premium paid through a salary reduction arrangement under a section 125 cafeteria plan is ***not*** counted in determining the premium expense.

Note: Premium contributions for owners and family members are **not** eligible expenses for the tax credit.

How is the average premium for the small group market in the state determined?

The Department of Health and Human Services (HHS) will determine the rate for a state (or within a state) and the information will be published on the IRS website (IRS.gov). The 2011 rates are available in an easy-to-read table.

> **Example: Calculating the credit for an employer (non–tax-exempt)**
> For tax year 2010, an employer has 9 FTEs with average annual wages of $23,000 per employee. The employer pays $72,000 in premiums for those employees (which does not exceed the benchmark premium) and meets the requirements for the credit. This employer's credit for 2010 equals $25,000 (35% X $72,000).
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> **Example: Calculating the credit for a tax-exempt employer**
> For tax year 2010, a tax-exempt employer has 9 FTEs with average annual wages of $23,000 per FTE. The employer pays $72,000 in premiums for those employees (which does not exceed the benchmark premium) and meets the requirements for the credit. The total for the employer's income tax and Medicare tax withholding, plus the employer's share of the Medicare tax withholding, equals $30,000.
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> Here's how the credit is calculated:
> 1) The initial amount of the credit is determined before any reduction: (25% X $72,000) = $18,000
> 2) The employer's withholding and Medicare taxes are $30,000
> 3) Total tax credit for 2010 is $18,000

How are annual average wages determined?

Average annual wages are calculated by dividing total wages paid by the employer to employees during a taxable year (box 5 of W-2 wages) by the number of FTEs for the year. The result is rounded down to the nearest $1,000.

> **Example**: For the tax year 2010, an employer pays $224,000 in wages and has 10 FTEs.
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> The employer's annual average wage would be: $22,000 ($224,000 divided by 10 = $22,400, rounded down to the nearest $1,000).

How is the tax credit calculated for employers with more than 10 FTEs and/or average annual wages over $25,000?

As long as the employer has fewer than 25 FTEs and pays annual average wages under $50,000 per FTE (and meets other specified requirements) they are eligible for a tax credit on a sliding scale basis. A standard formula is used to reduce the full tax credit.

If average annual wages exceed $25,000: The reduction is determined by multiplying the full credit amount by a fraction: the numerator is the amount by which average annual wages exceed $25,000 and the denominator is $25,000.

The amount calculated using the formula above is then subtracted from the full tax credit to determine the final credit the employer qualifies for. If the employer has both more than 10 FTEs and average annual wages over $25,000, the credit is determined by adding both reduction amounts together and subtracting that sum from the full credit amount.

Example: Calculating the sliding-scale tax credit
For the 2010 tax year, a qualified employer has 12 FTEs and average annual wages of $30,000. The employer pays $96,000 in healthcare premiums for those employees (which does not exceed the benchmark premium) and otherwise meets the requirements for the credit. The credit is calculated as follows:

1. Initial amount of credit determined before any reduction: (35% X $96,000) = $33,600
2. Credit reduction for FTEs in excess of 10: ($33,600 X 2/15) = $4,480
3. Credit reduction for average annual wages over $25,000: ($33,600 X $5,000/$25,000) = $6,720
4. Total credit reduction: ($4,480 + $6,720) = $11,200
5. Total 2010 tax credit: ($33,600 - $11,200) = $22,400.

To find out what percentage of the tax credit you will most likely qualify for given your number of employees and their average annual wages, see this chart provided by the Congressional Research Service.

Does the state tax credit or subsidy I receive reduce my federal tax credit?

According to the premium tax credit FAQ provided by the IRS: Although state tax credits and payments made directly to an employer generally do not reduce an employer's otherwise applicable federal health care tax credit, and although state direct payments are generally treated as paid on behalf of an employer, the federal health care tax credit cannot exceed the amount of the employer's net premium payments. In the case of a state tax credit for an employer or a state subsidy paid directly to an employer, the employer's net premium payments are calculated by subtracting the state tax credit or subsidy from the employer's actual premium payments. In the case of a state direct payment, the employer's net premium payments are the employer's actual premium payments.