Health Care Tax Credit: A Bonus for Small Businesses

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Every major piece of legislation has winners and losers. While there's plenty of speculation and argument about the winners and losers with health care reform, it's clear that some small employers will enjoy an immediate bonus in the form of a health insurance tax credit. The purpose of the credit is to encourage small companies with lower-paid workers to offer or continue to offer employer-subsidized health coverage to their employees. For these employers, the 2014 mandate to "play or pay" will not apply because of their size.

Who are the Winners?

The tax credit is available to any small employers that:

- Have no more than 25 full-time equivalent (FTE) employees for the tax year;
- Pay average annual wages that do not exceed $50,000 per FTE; and
- Pay at least 50% of the cost of health care coverage for employees – currently based on the single premium rate.

Both taxable (for-profit) companies and tax-exempt entities may qualify for the tax credit. Taxable companies will claim the credit against income tax liability on their annual income tax returns. The IRS is expected to provide additional information on how tax-exempt employers may claim the credit.

What's the Prize?

For the first four years – tax years beginning in 2010 through 2013 – an eligible small employer may claim a tax credit of up to 35% of the annual premiums it paid toward health insurance for employees. The limit is 25% for tax-exempt employers.

Beginning in 2014, the tax credit ceiling jumps to 50% (35% for tax-exempts). The full amount of the credit is available only to the smallest employers with the lowest paid workers – 10 or fewer FTE employees, and with average annual wages of $25,000 or less. The credit phases out gradually for companies with average wages between $25,000 and $50,000 and the equivalent of 10 to 25 full-time workers. And in order to discourage high-cost plans, the credit does not apply to premium amounts that exceed the average cost of health insurance in the state ($5,098 for single and $12,364 for family coverage for 2010 in Michigan).

After 2013, the tax credit can be claimed for only two additional tax years and the employer must offer health coverage to its workers through one of the new Exchanges (see page 11) to be created by each state by 2014.

Are There Other Rules?

In determining whether an employer is eligible for the credit, members of a controlled group (e.g., separate businesses with the same owners or a parent-subsidiary relationship) or an affiliated service group (related businesses where one performs services for the other) are treated as a single employer.

For purposes of determining average annual wages and the number of FTEs, seasonal workers are not counted unless they work more than 120 days during the tax year. No credit is available for self-employed individuals, including partners and sole proprietors, more than 2% shareholders of an S corporation, and 5% owners of the employer or their family/household members. Such individuals also are not counted in determining the number of FTE employees or average wages for employer eligibility purposes.

Finally, double-dipping is prohibited. That means the employer's deduction for employer-paid health insurance premiums is reduced by the amount of the small employer health insurance tax credit with respect to those premiums.

Employers Take Notice

The small business health care tax credit took effect January 1, 2010. This allows employers to count all premiums paid during the 2010 tax year for purposes of the credit. The government is eager for business owners to know about this new tax break, and in late April the IRS sent out more than 4 million postcards to small businesses urging them to determine if they qualify for the tax credit.

In addition, the IRS web site at www.irs.gov provides various scenarios and worksheets to help you determine whether you qualify as one of the early "winners."