Payroll Health Care Tax Credit

¶1301.2 Small employer health insurance credit for tax-exempt employers

To the practitioner:

For background information on this topic, see Federal Tax Coordinator ¶ L-15680 et seq.; United States Tax Reporter ¶ 45R4 et seq. This letter can be sent to small tax-exempt employers who might be interested in the tax benefits of providing health insurance to their employees. For a client letter on the same topic for small taxable employers, see ¶1301.1.

Dear Client:

I wanted to make sure you were aware of the tax credit available for certain small tax-exempt employers providing health insurance coverage for their employees. The credit is specifically targeted to help small businesses and tax-exempt organizations that primarily employ moderate-income workers and lower-income workers. For tax-exempt employers, the credit is a refundable tax credit limited to the amount of the payroll taxes (as defined below).

During the first phase of the credit, (i.e., tax years beginning in 2010, 2011, 2012, or 2013), the amount of a tax-exempt employer's credit is generally 25% of the employer's nonelective contributions toward the employees' health insurance premiums. In the second phase of the credit (i.e., tax years beginning after 2013), the amount of the credit is generally 35% of the nonelective contributions.

An employer qualifying for the credit (i.e., an eligible small employer or ESE) has to meet all of the following requirements:

1. The employer can't have more than 25 full-time equivalent (FTE) employees for the tax year. An employer's FTE employees are determined by dividing the total hours worked by all employees during the year by 2,080 (rounded down to the nearest whole number).

2. The average annual wages of the employees can't exceed $50,000 (for tax years beginning after 2013, the dollar amount is indexed for inflation) for the tax year. The average annual wages are determined by dividing the total wages the employer pays by the number of its FTE employees and then rounding that number down to the nearest $1,000.

3. The employer has to contribute at least 50% of the premiums for the employees' health insurance coverage on a uniform basis. However, for tax years beginning in 2010 only, an employer can meet this requirement even if it pays differing percentages of different employees' premiums as long as all employer payments are at least 50% of each employee's premium based on single (employee only) coverage.

In addition to satisfying the three requirements listed above, a tax-exempt ESE has to be an organization described in Code Sec. 501(c) (such as a charitable organization under Code Sec. 501(c)(3)) that is exempt from taxation under Code Sec. 501(a).

The amount of the credit gradually phases out if the number of an ESE's FTE employees exceeds ten or if the average annual wages of the employees exceed $25,000. Under the phaseout, the full amount of the credit is available only to an employer with ten or fewer FTE employees and whose employees have average annual wages of less than $25,000. However, an employer with exactly 25 FTE employees or average annual wages exactly equal to $50,000 is not in fact eligible for the credit. Since the eligibility rules are based in part on the number of FTE employees, not the number of employees, in certain circumstances, an organization that uses part-time help can qualify for the credit even if they employ more than 25 individuals.

A tax-exempt ESE's credit is limited to the amount of its payroll taxes during the calendar year in which the tax year begins. For this purpose, payroll taxes are amounts required to be withheld from the wages of the employees of the tax-exempt ESE as income tax withholding, amounts required to be withheld from the wages of the employees as Medicare taxes, and amounts of the taxes imposed on the tax-exempt ESE as the employer portion of Medicare taxes.

For the first phase of the credit, an ESE can claim the credit on qualifying health insurance purchased from an insurance company licensed under state law. If an employer pays only a portion of the premiums for the coverage provided to employees under the arrangement (with employees paying the rest), only the portion paid by the employer is taken into account. For example, if an employer pays 80% of the premiums for employees' coverage (with employees paying the other 20%), the 80% premium amount paid by the employer counts in calculating the amount of the credit.

For the second phase of the credit, the credit is only available if the ESE purchases health insurance coverage for its employees through a state exchange. Also, during the second phase, the credit is only available for a maximum coverage period of two consecutive tax years beginning with the first year in which the employer or any predecessor first offers one or more qualified plans to its employees through an exchange. The maximum two-year coverage period does not take into account any tax years beginning before 2014. Thus, an ESE can potentially qualify for the credit for six tax years, four years under the first phase and two years under the second phase.

Please let me know if you have any questions concerning the credit or if I can assist you in determining whether your organization can benefit from claiming the credit.

Sincerely,