

ROTROFF, FISHER & CO., P.A.

CERTIFIED PUBLIC ACCOUNTANTS

Dear Client:

Re: Small employer health insurance credit for taxable employers

We wanted to make sure you were aware of the tax credit available for certain small employers providing health insurance coverage for their employees. The credit is specifically targeted to help certain small businesses that primarily employ moderate-income workers and lower-income workers. The credit can offset a taxable employer's regular tax liability or its alternative minimum tax (AMT) liability.

During the first phase of the credit (i.e., tax years beginning in 2010, 2011, 2012, or 2013), the amount of the credit is generally 35% 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 50% of the employer's nonelective contributions. The amount of the credit is subject to a phaseout (described below).

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.

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, a business that uses part-time help can qualify for the credit even if it employs more than 25 individuals.

For purposes of determining whether an employer is an ESE and determining the amount of the credit, self-employed individuals, including partners and sole proprietors, 2% shareholders of an S corporation, and 5% owners of the employer and certain relatives of these individuals are not treated as employees for purposes of the small employer health insurance credit. There are also special rules that apply to seasonal workers, leased employees, and employees who have more than 2,080 hours of service during a tax year.

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.

An employer is entitled to an ordinary and necessary business expense deduction equal to the amount of the employer contribution minus the dollar amount of the credit. For example, if an ESE pays 100% of the cost of its employees' health insurance coverage and the amount of the tax credit is 50% of that cost (i.e., in tax years beginning after 2013), the employer can claim a deduction for the remaining 50% of the premium cost. Any unused credit can be carried back for one year (but not before 2010) and forward for 20 years to offset future taxes.

Please let us know if you have any questions concerning the credit or if we can assist you in determining whether your business can benefit from claiming the credit.

Sincerely,


Rotroff, Fisher & Co., P.A.