

New Health Credit for Small Business Owners

Most changes in the new health care legislation will take place over the next few years. But one provision has an immediate effect: Starting in 2010, certain small businesses may use a special tax credit to offset health insurance costs. The IRS recently issued preliminary guidance on this new health care credit.

Background: Under the Patient Protection and Affordable Care Act of 2010, an eligible small employer can claim the credit for nonelective contributions to purchase health insurance for its employees in tax years beginning after 2009. For this purpose, an "eligible small employer" is an employer with fewer than 25 full-time equivalent employees (FTEs) with annual wages of less than \$50,000.

However, the full amount of the credit is available only if the employer has ten or fewer FTEs with average annual wages of less than \$25,000. The credit is reduced for employers falling in between.

How it works: The credit is initially available in any tax year beginning in 2010, 2011, 2012 or 2013. The applicable credit percentage is 35% of the employer's contributions (25% for tax-exempt organizations). For tax years beginning after 2013, the credit may be claimed only for a two-year period and only if the health insurance is purchased through a state-operated exchange. The credit percentage is 50% of the employer's contributions (35% for tax-exempt organizations).

Under the new IRS guidance, the maximum health insurance credit is reduced by 6.667% for each full-time employee over ten employees. The credit is also reduced by 4% for each \$1,000 that average annual wages paid to FTEs exceed \$25,000. For this purpose, the IRS says the number of FTEs is determined by dividing the total hours for which employees are compensated (but not more than 2,080 hours per employee) by 2,080. When appropriate, round to the next lowest whole number.

Example: XYZ Corp. has a total of ten employees in 2010. Five are paid wages based on 2,080 hours for the year, one is paid based on 2,400 hours and the remaining four are paid for 1,040 hours. The calculation is as follows:

5 employees working 2,080 hours = 10,400 hours

1 employee working 2,400 hours = 2,400 hours

4 employees working 1,040 hours = 4,160 hours

16,960 total hours divided by 2,080 = 8.15

8.15 rounded to 8 FTEs

Result: XYZ Corp. qualifies for the full credit.

Note that seasonal or part-time workers will not affect the outcome. Also, the calculation does not include wages of a sole proprietor, a partner, a 2%-or-more S corporation shareholder or any other employee owning more than 5% of another business. Finally, other relatives of the business owners are generally excluded.

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The credit is claimed as part of the general business credit. It can be carried back for one year (beginning in 2011) and forward for 20 years. It may also offset alternative minimum tax (AMT) liability. Consult a professional adviser for application of these rules.