

May 11, 2010

Dear Client:

With relatively little fanfare, the Hiring Incentives to Restore Employment Act (the HIRE Act) became law on March 18, 2010. The legislation includes three business tax breaks intended to boost hiring along with a package of changes intended to tighten the screws on offshore transactions and entities that Congress thinks can be used to hide income and assets from the IRS. This letter summarizes what we think are the key points.

Information related to the HIRE act starts on page 2 and continues through page 4.

Additionally, on March 30, 2010, President Obama signed into law the final piece of his promised Health Reform legislation. This is landmark legislation that will result in a monumental shift in how health care is delivered in this country. Once fully phased in (which isn't scheduled to happen until 2018), the legislation will provide health care coverage to some 32 million uninsured and make it more affordable for millions more by expanding Medicaid, requiring the establishment of state-run Insurance Exchanges through which certain individuals and families can receive federal subsidies (credits) to substantially reduce the cost, forbidding insurance companies from excluding coverage for pre-existing conditions (effective this year for children and in 2014 for adults), establishing temporary (through 2014) high-risk insurance pools for adults with pre-existing conditions, and requiring health plans to allow parents to keep their children on their family plans until they reach age 26.

Obviously, this is not a cheap undertaking—the 10-year price tag is estimated to be \$938 billion, which is paid for through tax increases on higher income taxpayers, Medicare reimbursement savings, and various revenue raisers targeting specific health-related industries. Also, as is often the case, many of the carrots and sticks designed to persuade people to act appropriately (i.e., to get or provide health insurance coverage) reside in our tax system. Namely, small employers are provided tax credits to encourage them to provide employee health coverage. Large employers are assessed excise taxes to discourage them from not providing employee health coverage (or providing unaffordable or inadequate coverage), while individuals are assessed excise taxes to discourage them from opting out of coverage.

Information related to the Health Reform legislation starts on page 5.

Additionally, the attached Appendix A, starting on page 10 is the Q&A from the IRS related to the refundable Small Business Health Care Tax Credit ("premium assistance credit") for qualifying health insurance. The qualifications and computations for this credit are fairly complex and this Q&A is currently the best resource for how to determine if your company qualifies for the credit and how to compute it.

For 2010 and 2011 - the most important tax issues are:

1. The increased Section 179 deduction for 2010 only, page 2
2. The Temporary Employer Social Security Tax Exemption, page 2
3. The Temporary Tax Credit for Retaining Qualified New Employees, page 2
4. New report for offshore investment, page 3
5. The Small Employer Health Insurance Tax Credit, page 5

HIRE Act

Business Breaks

Generous Section 179 Deduction Rules Extended through 2010. The HIRE Act extends the generous \$250,000 Section 179 first-year depreciation write-off for one year, to cover tax years beginning in 2010. The new law also extends the \$800,000 threshold for the Section 179 deduction phase-out rule to cover tax years beginning in 2010. Other favorable Section 179 deduction rules also apply in 2010. For example, Section 179 deductions can still be claimed for purchased software.

Note: For tax years beginning in 2011, the maximum Section 179 deduction will fall all the way back to \$25,000 unless Congress takes further action. The phase-out threshold will fall all the way back to \$200,000. Also, some of the other favorable Section 179 rules end after 2010.

Temporary Employer Social Security Tax Exemption for Wages Paid to New Hires. Wages paid by a *qualified employer* to a *qualified new employee* for employment between 3/19/10 and 12/31/10 are exempt from the 6.2% employer portion of the Social Security tax. However, there's no exemption for the 6.2% *employee* portion of the tax, and there's no break for individuals who pay self-employment tax.

The maximum amount of employer Social Security tax savings for a high-paid employee is \$6,621.60 (6.2% × \$106,800 Social Security tax ceiling for 2010). Savings will be less for lower-paid employees and for higher-paid workers who are paid less than \$106,800 for employment between 3/19/10 and year-end.

Qualified employers include private-sector businesses, tax-exempt not-for-profits, and eligible public higher-education institutions.

Qualified new employees are full-time or part-time workers who start work between 2/4/10 and 12/31/10 and who were not employed more than 40 hours during the 60-day period ending on their start dates. However, the new worker cannot replace another worker unless that person quit voluntarily or was discharged for cause.

The IRS has developed new form W-11 that must be signed by the employee to have them certify that they meet the requirements of a qualified new employee.

To give both employers and the IRS time to gear up for this new Social Security tax exemption deal, the benefit of the exemption for any eligible wages paid during March will be reflected as a credit on the employer's federal employment tax return (Form 941) for the second quarter of 2010. The first quarter return is unaffected.

Temporary Tax Credit for Retaining Qualified New Employees. Above and beyond the temporary Social Security tax exemption explained above, employers can also claim a temporary new tax credit of up to \$1,000 for wages paid to each *qualified new employee*, using the same definition as for the Social Security tax exemption.

There are some additional requirements for the credit. The worker must be kept on the payroll for at least 52 consecutive weeks, and wages during the second 26 weeks of the 52-week period must equal at least 80% of wages paid during the first 26 weeks of that period.

The credit amount equals the lesser of 6.2% of wages paid during the 52-consecutive-week period or \$1,000. To claim the maximum \$1,000 credit, the worker must be paid at least \$16,130 during the 52-week period.

The credit can only be claimed for the tax year ending after 3/18/10 during which the 52-week requirement is first met for the applicable worker. So, the credit is a one-time deal for each eligible worker, based on wages paid during the 52-week period that starts with the worker's employment date.

Because the 52-week requirement cannot be met until February of 2011 at the soonest, the credit can't be claimed on a calendar-year 2010 return. Instead, you'll have to wait until your calendar-year 2011 return is filed. If your business uses a fiscal tax year, you too will have to wait a while to collect your rightful credit. Even so, hiring a qualified new employee now and retaining that individual for at least 52 weeks can generate a credit that will eventually save taxes.

This credit becomes a component of the overall general business credit and is therefore subject to limitations of the general business credit and applies against normal income taxes, but does not reduce alternative minimum tax (AMT).

Strict New Rules to Clamp Down On Offshore Tax Evasion

Individuals Must Disclose Foreign Financial Assets. For tax years beginning after 3/18/10, the new law will require new tax return disclosures from individuals with interests in "specified foreign financial assets" if the aggregate value of such assets exceeds \$50,000. Specified financial assets include depository and custodial accounts at foreign financial institutions; foreign stocks and securities that are not held in such accounts; certain other financial instruments and contracts that are held for investment but that are not held in such accounts; and interests in foreign entities that are not held in such accounts. Failure to make required disclosures can result in a \$10,000 penalty. Failure to provide required disclosures for more than 90 days after the IRS notifies the taxpayer of such a failure to disclose can result in additional penalties of \$10,000 per 30-day period or any part of a 30-day period.

New 40% Penalty on Tax Understatements Attributable to Undisclosed Foreign Financial Assets. For tax years beginning after 3/18/10, the HIRE Act imposes a stiff 40% penalty on any understated amount of tax that is attributable to an undisclosed foreign financial asset. An understatement is considered attributable to an undisclosed foreign financial asset if it is attributable to *any transaction* involving such an asset.

New Six-year Statute of Limitations on Tax Understatements Attributable to Foreign Financial Assets. Usually, the IRS only has three years after a tax return for a particular year is filed to assess additional taxes for that year. After this three-year “statute of limitations” period expires, the taxpayer is generally off the hook for that year. The new law establishes a six-year statute of limitations period for tax understatements attributable to certain understated income from foreign financial assets. The understated income must exceed \$5,000.

Statute of Limitations Suspended for Failures to Report Foreign Financial Assets. The HIRE Act suspends the statute of limitations period if the taxpayer fails to make required tax return disclosures for foreign financial assets.

Unfavorable New Rules for Foreign Trusts. Effective 3/18/10, the new law creates a more expansive definition of “beneficiary” for purposes of determining when a foreign trust is treated as a grantor trust owned by a U.S. beneficiary. This is important because taxpayers treated as grantors must report their shares of foreign trust income on their federal income tax returns.

In general, for transfers of property after 3/18/10 by a U.S. taxpayer to a foreign trust, the HIRE Act creates a rebuttable presumption that the trust is a grantor trust owned by a U.S. beneficiary. This unfavorable presumption applies unless the U.S. taxpayer is able to rebut it by submitting information that proves no part of the trust income or corpus has accrued to the benefit of a U.S. person.

For tax years beginning after 3/18/10, the new law requires U.S. taxpayers that are treated as grantors (owners) of foreign trusts to report whatever information about such trusts as the IRS may mandate. This is on top of the pre-existing requirement for U.S. grantors to ensure that such trusts comply with return filing and information reporting requirements.

For failures to file required returns and notices due after 12/31/09 for foreign trusts, the HIRE Act imposes a minimum \$10,000 penalty.

Health Care Reform

This Health Reform legislation is massive—it is well over a thousand pages—and covers numerous areas, both tax and nontax. This letter briefly summarizes the tax provisions affecting individuals and small to mid-sized businesses and is presented based on the timeline for when the provisions are scheduled to take effect.

Provisions Effective in 2010

Small Employer Health Insurance Tax Credit. Effective this year and going through 2013, the Health Reform legislation provides a new tax credit for small employers that purchase health insurance for their employees. To be a small employer qualifying for this new credit you must—

1. employ no more than 25 Full-time Equivalent (FTE) employees during the tax year,
2. pay annual FTE wages that average no more than \$50,000 for the year, and
3. have a qualified health insurance plan (or arrangement) under which you pay at least 50% of the premiums (on a uniform basis) for employees who enroll in the plan.

Generally, to qualify for the credit, the employer must pay the same percentage (which has to be at least 50%) of all its employees' premiums. However, under a transition rule for 2010 only, an employer can qualify even if it pays differing percentages of different employees' premiums as long as all the employer payments are at least 50% of each employee's premium (based on single-employee only—coverage). Also, premiums paid in 2010 before the Health Reform legislation was enacted can qualify for the credit.

The credit generally equals 35% of the amounts paid by the employer during the year for employee coverage. However, the full amount of the credit is available only for employers that employ 10 or fewer FTE employees and have average annual FTE wages of less than \$25,000 for the year. Also, no credit is allowed for premiums paid on behalf of partners, sole proprietors, 2% shareholders of an S corporation, 5% owners of the employer, and dependents of these individuals. Other limitations may apply as well.

The small employer health insurance credit will be claimed on the employer's income tax return. It can offset regular income taxes and alternative minimum tax. Any unused credit can be carried back for one year (but not before 2010) and forward for 20 years to offset future taxes.

For tax-exempt employers, the IRS will provide further information on how to claim the credit.

Note: In 2014 and later, eligible small employers who purchase coverage through a state-run Insurance Exchange (which the Health Reform legislation requires states to establish) will be eligible for a tax credit for two years of up to 50% of their contribution. Also, the wage limits will be indexed beginning in 2014.

Liberalized Adoption Credit and Adoption Assistance Exclusion. For 2010, the Health Reform legislation increases the adoption credit and the employer-provided adoption assistance exclusion to \$13,170 (from \$12,170). It also makes the credit refundable and extends both the exclusion and credit through 2011.

Dependent Coverage in Employer Health Plans. Effective 3/30/10, the Health Reform legislation provides that self-employed individuals can deduct (as a self-employed medical insurance deduction on page 1 of Form 1040) insurance coverage for their children who have not attained age 27 as of the end of the year. Similarly, employees can exclude from their taxable income the amounts their employer pays for health care insurance and expense reimbursements for their children who have not attained age 27 as of the end of the year. To qualify for this tax break, the child must be the individual's son, daughter, stepson, stepdaughter or eligible foster child. The child does not have to be the individual's dependent.

Although the exclusion for employer-provided health coverage for under-age-27 dependents is effective 3/30/10, employers don't have to provide health coverage of these adult children if they don't otherwise cover dependents. If the employer plan does cover dependents, it must change its definition of "dependent" to include an employee's unmarried children up to age 26, but not until its plan year beginning after 9/22/10. Thus, employees may well have to wait until 2011 before they have an opportunity to cover these adult children and even then, only if their employer's health plan otherwise covers dependents and the child is unmarried and under age 26. (The under-age-26 and marital status requirements appear to be a glitch in the law. Hopefully, future legislation will change this definition so that it is the same as for the income exclusion requirement where the child simply has to be under age 27.)

Codification of Economic Substance Doctrine and Imposition of Penalties. The economic substance doctrine is a judicial doctrine that the courts have used inconsistently over the years to deny tax benefits when the transaction generating these tax benefits lacked economic substance. The Health Reform legislation clarifies the manner in which the economic substance doctrine should be applied by the courts. It also imposes a 20% penalty on understatements attributable to a transaction lacking economic substance.

Provisions Effective in 2011

Cost of Employer Sponsored Health Coverage Included on Form W-2. Beginning in 2011, employers will have to start reporting the value of health insurance coverage they provide to employees on the employee's Form W-2.

Over-the-counter Medicine No Longer Reimbursable by Health Plans. Under pre-Health Reform law, health plans [including health FSAs, Health Reimbursement Accounts (HRAs), Health Savings Accounts (HSAs), and Archer Medical Savings Accounts (MSAs)] could reimburse, on a tax-free basis, the cost of medicine regardless of whether it was prescribed by a doctor. On the other hand, only medicine (other than insulin) that required a doctor's prescription was deductible for income tax purposes (as an itemized deduction). Beginning in 2011, the Health Reform legislation provides that only insulin and doctor prescribed medicine qualifies for tax-free reimbursement through a health FSA, HRA, HSA, or Archer MSA. Thus, as with the itemized deduction for medical expenses, nonprescribed medicine (other than insulin) will not qualify for tax-free reimbursement.

Increased Tax on Nonqualifying HSA and Archer MSA Distributions. Beginning in 2011, the additional tax for HSA withdrawals made before the owner turns age 65 that are not used for qualified medical expenses is increased from 10% to 20%. Similarly, the additional tax for post-2010 Archer MSA withdrawals that are not used for qualified medical expenses is increased from 15% to 20%.

Simple Cafeteria Plans Available for Small Employers. Starting in 2011, a new cafeteria plan, known as a Simple Cafeteria Plan, will be available to small employers that employed an average of 100 or fewer employees during either of the two preceding years. Basically, the Simple Cafeteria Plan and the benefits it provides (including group term life insurance, self insured medical expense reimbursements, and dependent care assistance) will be treated as meeting the applicable nondiscrimination rules if the cafeteria plan satisfies certain minimum eligibility, participation, and contribution requirements. This should make it simpler for small employers to provide tax-free benefits to their employees.

Provisions Effective in 2012

Corporate Information Reporting. Beginning in 2012, businesses that pay more than \$600 during the year to corporate providers of property and services will have to file an information report with each provider and the IRS. This will likely be done on Form 1099-MISC, Miscellaneous Income.

Provisions Effective in 2013

Additional Hospital Insurance (HI) Tax for High Wage Workers. Beginning in 2013, the employee portion of the HI tax rate will be increased by 0.9% for employees who earn wages over \$200,000 (\$250,000 for married couples filing jointly or \$125,000 for married filing separate). Similarly, an additional HI tax of 0.9% will be imposed on self-employment income in excess over \$200,000 (\$250,000 for married couples filing jointly or \$125,000 for married filing separate) reduced (but not below zero) by wages taken into account in determining the FICA tax with respect to the taxpayer.

Note: The \$150,000/\$200,000/\$250,000 thresholds are not indexed for inflation.

New 3.8% Surtax on Unearned Income. Beginning in 2013, taxpayers with modified adjusted gross income (MAGI) over \$200,000 (\$250,000 for a joint return or \$125,000 for married filing separate) will be subject to a 3.8% surtax (called the Unearned Income Medicare Contribution) on net investment income. Specifically, the tax equals 3.8% of the lesser of the following two amounts:

1. Net investment income (basically, interest, dividends, royalties, rents, and gains on the sale of investment property).
2. The excess of MAGI over \$200,000 (\$250,000 for a joint return or \$125,000 for married filing separate). MAGI is AGI increased by the amount excluded from income as foreign earned income, net of the deductions and exclusions disallowed with respect to the foreign earned income.

The tax also applies to estates and trusts. In this case, the tax is 3.8% of the lesser of (1) undistributed net investment income or (2) the excess of AGI over the dollar amount at which the highest estate and trust income tax bracket begins.

Increased Medical Expense Deduction Threshold. Beginning in 2013, the threshold for the itemized deduction for medical expenses for regular income tax purposes will be increased from 7.5% of AGI to 10% of AGI. However, for 2013 through 2016, if either the taxpayer or the taxpayer's spouse turns 65 before the end of the tax year, the increase won't apply and the

threshold will remain at 7.5% of AGI. Thus, the 10% threshold won't apply to seniors and their spouses until after 2016.

New Limit on Health FSA Contributions. Beginning in 2013, the maximum amount that an individual can contribute to an employer-provided health Flexible Spending Account (FSA) will be \$2,500 per year. Note, however, that health FSA plans can (and typically do) limit contributions to an amount that is less than \$2,500 per year. Therefore, this change may have little or no impact on you.

Deduction for Retiree Drug Coverage Eliminated. A number of large employers provide prescription drug coverage for their Medicare Part D eligible retirees, which is subsidized by the Department of Health and Human Services (HHS). This subsidy is excluded from the company's income, and under pre-Health Reform law, it did not reduce the deduction otherwise allowed for the payment. Starting in 2013, this is no longer true—the subsidy will reduce the allowed deduction. (As a result of this change, several large companies have already announced that they are reconsidering providing this retiree benefit.)

Provisions Effective in 2014

Penalty for Not Having Health Insurance Coverage. Beginning in 2014, most U.S. citizens and legal residents will have to maintain health care coverage or pay a penalty based on their household income and the number of uninsured individuals in the household. The penalty per household will generally be capped at \$285 for 2014, \$975 for 2015, and \$2,085 for 2016. Individuals who, based on their household income, can't afford coverage under their employer sponsored health plan are exempted from the penalty, as are individuals who reside outside the U.S. and those with certain religious beliefs.

This penalty was provided as a means to entice individuals to obtain health insurance coverage. Payment of the penalty does not entitle them to any health insurance coverage.

Health Care Cost-sharing Subsidies (or Tax Credits) Available to Low-income Individuals. Beginning in 2014, a cost-sharing subsidy (or tax credit) will be provided to low-income individuals to help cover their health insurance costs. Basically, individuals and families with incomes up to 400% of the federal poverty level (\$43,320 for an individual or \$88,200 for a family of four for 2009) that are not eligible for Medicaid, employer sponsored insurance, or other acceptable coverage will be able to obtain cost-sharing subsidies or tax credits that can be used to reduce premiums for health insurance obtained through the newly established state-run Insurance Exchanges.

Penalty for Employers Not Offering Affordable or Adequate Health Insurance Coverage. Beginning in 2014, *large employers* not offering health insurance coverage for all their full-time employees, or offering unaffordable or inadequate health insurance coverage, will have to pay a penalty if *any* full-time employee uses a tax credit or cost-sharing subsidy to purchase health insurance through a state-run Insurance Exchange. A *large employer* is generally, an employer that employed an average of at least 50 full-time employees during the preceding calendar year. Any penalty paid under this provision is not deductible as a business expense.

Free Choice Vouchers. Beginning in 2014, employers that have a health plan (or arrangement) under which they pay a portion of their employees' health insurance coverage will have to

provide certain low-income employees who don't participate in the employer's plan with a voucher (equal to the amount the employer would have contributed to the employer-offered health plan if the employee had participated) that can be applied to purchase health insurance through a state run Insurance Exchange.

Provisions Effective in 2018

Excise Tax on High-cost Employer-sponsored Health Coverage (Cadillac Plans). The last piece of the Health Reform legislation kicks in for 2018 when a nondeductible excise tax will be levied on so-called Cadillac plans – basically health plans with annual premiums exceeding \$10,200 for single coverage and \$27,500 for family coverage.

However, higher thresholds apply for retired individuals age 55 and older and for plans that cover employees engaged in high-risk professions. The excise tax will be levied at the insurer level. Employers will be required to aggregate the coverage subject to the limit and issue information returns for insurers indicating the amount subject to the excise tax.

Conclusion

There you have it – a brief summary of the Health Reform Act tax provisions affecting individuals and small to midsized businesses.

The HIRE Act starts off with some good news for business taxpayers. Then, it puts the hammer down on taxpayers with offshore investments and transactions.

In this letter, we have only covered what we think are the most important of these changes. There's much more that some taxpayers will need to know. Please contact us if you have questions or want more detailed information.

Best regards,

McDonald Jacobz, P.C.

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Appendix A

IRS Q&A on the Small Business Health Care Credit

This information can be found on the web at: <http://www.irs.gov/newsroom/article/0,,id=220839,00.html>

Small Business Health Care Tax Credit: Frequently Asked Questions

The new health reform law gives a tax credit to certain small employers that provide health care coverage to their employees, effective with tax years beginning in 2010. The following questions and answers provide information on the credit as it applies for 2010-2013, including information on transition relief for 2010. An enhanced version of the credit will be effective beginning in 2014. The new law, the Patient Protection and Affordable Care Act, was passed by Congress and was signed by President Obama on March 23, 2010.

Employers Eligible for the Credit

1. Which employers are eligible for the small employer health care tax credit?

A. Small employers that provide health care coverage to their employees and that meet certain requirements (“qualified employers”) generally are eligible for a Federal income tax credit for health insurance premiums they pay for certain employees. In order to be a qualified employer, (1) the employer must have fewer than 25 full-time equivalent employees (“FTEs”) for the tax year, (2) the average annual wages of its employees for the year must be less than \$50,000 per FTE, and (3) the employer must pay the premiums under a “qualifying arrangement” described in Q/A-3. See Q/A-9 through 15 for further information on calculating FTEs and average annual wages and see Q/A-22 for information on anticipated transition relief for tax years beginning in 2010 with respect to the requirements for a qualifying arrangement.

2. Can a tax-exempt organization be a qualified employer?

A. Yes. The same definition of qualified employer applies to an organization described in Code section 501(c) that is exempt from tax under Code section 501(a). However, special rules apply in calculating the credit for a tax-exempt qualified employer. A governmental employer is not a qualified employer unless it is an organization described in Code section 501(c) that is exempt from tax under Code section 501(a). See Q/A-6.

Calculation of the Credit

3. What expenses are counted in calculating the credit?

A. Only premiums paid by the employer under an arrangement meeting certain requirements (a “qualifying arrangement”) are counted in calculating the credit. Under a qualifying arrangement, the employer pays premiums for each employee enrolled in health care coverage offered by the employer in an amount equal to a uniform percentage (not less than 50 percent) of the premium cost of the coverage. See Q/A-22 for information on transition relief for tax years beginning in 2010 with respect to the requirements for a qualifying arrangement.

If an employer pays only a portion of the premiums for the coverage provided to employees under the arrangement (with employees paying the rest), the amount of premiums counted in calculating the credit is only the portion paid by the employer. For example, if an employer pays 80 percent of the premiums for employees' coverage (with employees paying the other 20 percent), the 80 percent premium amount paid by the employer counts in calculating the credit. For purposes of the credit (including the 50-percent requirement), any premium paid pursuant to a salary reduction arrangement under a section 125 cafeteria plan is not treated as paid by the employer.

In addition, the amount of an employer's premium payments that counts for purposes of the credit is capped by the premium payments the employer would have made under the same arrangement if the average premium for the small group market in the State (or an area within the State) in which the employer offers coverage were substituted for the actual premium. If the employer pays only a portion of the premium for the coverage provided to employees (for example, under the terms of the plan the employer pays 80 percent of the premiums and the employees pay the other 20 percent), the premium amount that counts for purposes of the credit is the same portion (80 percent in the example) of the premiums that would have been paid for the coverage if the average premium for the small group market in the State were substituted for the actual premium.

4. What is the average premium for the small group market in a State (or an area within the State)?

A. The average premium for the small group market in a State (or an area within the State) will be determined by the Department of Health and Human Services (HHS) and published by the IRS. Publication of the average premium for the small group market on a State-by-State basis is expected to be posted on the IRS website by the end of April.

5. What is the maximum credit for a qualified employer (other than a tax-exempt employer)?

A. For tax years beginning in 2010 through 2013, the maximum credit is 35 percent of the employer's premium expenses that count towards the credit, as described in Q/A-3.

Example. For the 2010 tax year, a qualified employer has 9 FTEs with average annual wages of \$23,000 per FTE. The employer pays \$72,000 in health care premiums for those employees (which does not exceed the average premium for the small group market in the employer's State) and otherwise meets the requirements for the credit. The credit for 2010 equals \$25,200 (35% x \$72,000).

6. What is the maximum credit for a tax-exempt qualified employer?

A. For tax years beginning in 2010 through 2013, the maximum credit for a tax-exempt qualified employer is 25 percent of the employer's premium expenses that count towards the credit, as described in Q/A-3. However, the amount of the credit cannot exceed the total amount of income and Medicare (i.e., Hospital Insurance) tax the employer is required to withhold from employees' wages for the year and the employer share of Medicare tax on employees' wages.

Example. For the 2010 tax year, a qualified tax-exempt employer has 10 FTEs with average annual wages of \$21,000 per FTE. The employer pays \$80,000 in health care premiums for those employees (which does not exceed the average premium for the small group market in the employer's State) and otherwise meets the requirements for the credit. The total amount of the employer's income tax and Medicare tax withholding plus the employer's share of the Medicare tax equals \$30,000 in 2010.

The credit is calculated as follows:

- (1) Initial amount of credit determined before any reduction: $(25\% \times \$80,000) = \$20,000$
- (2) Employer's withholding and Medicare taxes: \$30,000
- (3) Total 2010 tax credit is \$20,000 (the lesser of \$20,000 and \$30,000).

7. How is the credit reduced if the number of FTEs exceeds 10 or average annual wages exceed \$25,000?

A. If the number of FTEs exceeds 10 or if average annual wages exceed \$25,000, the amount of the credit is reduced as follows (but not below zero). If the number of FTEs exceeds 10, the reduction is determined by multiplying the otherwise applicable credit amount by a fraction, the numerator of which is the number of FTEs in excess of 10 and the denominator of which is 15. If average annual wages exceed \$25,000, the reduction is determined by multiplying the otherwise applicable credit amount by a fraction, the numerator of which is the amount by which average annual wages exceed \$25,000 and the denominator of which is \$25,000. In both cases, the result of the calculation is subtracted from the otherwise applicable credit to determine the credit to which the employer is entitled. For an employer with both more than 10 FTEs and average annual wages exceeding \$25,000, the reduction is the sum of the amount of the two reductions. This sum may reduce the credit to zero for some employers with fewer than 25 FTEs and average annual wages of less than \$50,000.

Example. For the 2010 tax year, a qualified employer has 12 FTEs and average annual wages of \$30,000. The employer pays \$96,000 in health care premiums for those employees (which does not exceed the average premium for the small group market in the employer's State) and otherwise meets the requirements for the credit.

The credit is calculated as follows:

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

8. Can premiums paid by the employer in 2010, but before the new health reform legislation was enacted, be counted in calculating the credit?

A. Yes. In computing the credit for a tax year beginning in 2010, employers may count all premiums described in Q/A-3 for that tax year.

Determining FTEs and Average Annual Wages

9. How is the number of FTEs determined for purposes of the credit?

A. The number of an employer's FTEs is determined by dividing (1) the total hours for which the employer pays wages to employees during the year (but not more than 2,080 hours for any employee) by (2) 2,080. The result, if not a whole number, is then rounded to the next lowest whole number. See Q/A-12 through 14 for information on which employees are not counted for purposes of determining FTEs.

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.

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 ($5 \times 2,080$)
- b. 3,120 hours for the 3 employees paid for 1,040 hours each ($3 \times 1,040$)
- c. 2,080 hours for the 1 employee paid for 2,300 hours (lesser of 2,300 and 2,080)

These add up to 15,600 hours

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

10. How is the amount of average annual wages determined?

A. The amount of average annual wages is determined by first dividing (1) the total wages paid by the employer to employees during the employer's tax year by (2) the number of the employer's FTEs for the year. The result is then rounded down to the nearest \$1,000 (if not otherwise a multiple of \$1,000). For this purpose, wages means wages as defined for FICA purposes (without regard to the wage base limitation). See Q/A-12 through 14 for information on which employees are not counted as employees for purposes of determining the amount of average annual wages.

Example. For the 2010 tax year, an employer pays \$224,000 in wages and has 10 FTEs.

The employer's average annual wages would be: \$22,000 ($\$224,000$ divided by 10 = $\$22,400$, rounded down to the nearest \$1,000)

11. Can an employer with 25 or more employees qualify for the credit if some of its employees are part-time?

A. Yes. Because the limitation on the number of employees is based on FTEs, an employer with 25 or more employees could qualify for the credit if some of its employees work part-time. For example, an employer with 46 half-time employees (meaning they are paid wages for 1,040 hours) has 23 FTEs and therefore may qualify for the credit.

12. Are seasonal workers counted in determining the number of FTEs and the amount of average annual wages?

A. Generally, no. Seasonal workers are disregarded in determining FTEs and average annual wages unless the seasonal worker works for the employer on more than 120 days during the tax year.

13. If an owner of a business also provides services to it, does the owner count as an employee?

A. Generally, no. A sole proprietor, a partner in a partnership, a shareholder owning more than two percent of an S corporation, and any owner of more than five percent of other businesses are not considered employees for purposes of the credit. Thus, the wages or hours of these business owners and partners are not counted in determining either the number of FTEs or the amount of average annual wages, and premiums paid on their behalf are not counted in determining the amount of the credit.

14. Do family members of a business owner who work for the business count as employees?

A. Generally, no. A family member of any of the business owners or partners listed in Q/A-13, or a member of such a business owner's or partner's household, is not considered an employee for purposes of the credit. Thus, neither their wages nor their hours are counted in determining the number of FTEs or the amount of average annual wages, and premiums paid on their behalf are not counted in determining the amount of the credit. For this purpose, a family member is defined as a child (or descendant of a child); a sibling or step-sibling; a parent (or ancestor of a parent); a step-parent; a niece or nephew; an aunt or uncle; or a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law or sister-in-law.

15. How is eligibility for the credit determined if the employer is a member of a controlled group or an affiliated service group?

A. Members of a controlled group (e.g., businesses with the same owners) or an affiliated service group (e.g., related businesses of which one performs services for the other) are treated as a single employer for purposes of the credit. Thus, for example, all employees of the controlled group or affiliated service group, and all wages paid to employees by the controlled group or affiliated service group, are counted in determining whether any member of the controlled group or affiliated service group is a qualified employer. Rules for determining whether an employer is a member of a controlled group or an affiliated service group are provided under Code section 414(b), (c), (m), and (o).

How to Claim the Credit

16. How does an employer claim the credit?

- A. The credit is claimed on the employer's annual income tax return. For a tax-exempt employer, the IRS will provide further information on how to claim the credit.

17. Can an employer (other than a tax-exempt employer) claim the credit if it has no taxable income for the year?

- A. Generally, no. Except in the case of a tax-exempt employer, the credit for a year offsets only an employer's actual income tax liability (or alternative minimum tax liability) for the year. However, as a general business credit, an unused credit amount can generally be carried back one year and carried forward 20 years. Because an unused credit amount cannot be carried back to a year before the effective date of the credit, though, an unused credit amount for 2010 can only be carried forward.

18. Can a tax-exempt employer claim the credit if it has no taxable income for the year?

- A. Yes. For a tax-exempt employer, the credit is a refundable credit, so that even if the employer has no taxable income, the employer may receive a refund (so long as it does not exceed the income tax withholding and Medicare tax liability, as discussed in Q/A-6).

19. Can the credit be reflected in determining estimated tax payments for a year?

- A. Yes. The credit can be reflected in determining estimated tax payments for the year to which the credit applies in accordance with regular estimated tax rules.

20. Does taking the credit affect an employer's deduction for health insurance premiums?

- A. Yes. In determining the employer's deduction for health insurance premiums, the amount of premiums that can be deducted is reduced by the amount of the credit.

21. May an employer reduce employment tax payments (i.e., withheld income tax, social security tax, and Medicare tax) during the year in anticipation of the credit?

- A. No. The credit applies against income tax, not employment taxes.

Anticipated Transition Relief for Tax Years Beginning in 2010

22. Is it expected that any transition relief will be provided for tax years beginning in 2010 to make it easier for taxpayers to meet the requirements for a qualifying arrangement?

- A. Yes. The IRS and Treasury intend to issue guidance that will provide that, for tax years beginning in 2010, the following transition relief applies with respect to the requirements for a qualifying arrangement described in Q/A-3:

(a) An employer that pays at least 50% of the premium for each employee enrolled in coverage offered to employees by the employer will not fail to maintain a qualifying arrangement merely because the employer does not pay a uniform percentage of the premium for each such employee. Accordingly, if the employer otherwise satisfies the requirements for the credit described above, it will qualify for the credit even though the percentage of the premium it pays is not uniform for all such employees.

(b) The requirement that the employer pay at least 50% of the premium for an employee applies to the premium for single (employee-only) coverage for the employee. Therefore, if the employee is receiving single coverage, the employer satisfies the 50% requirement with respect to the employee if it pays at least 50% of the premium for that coverage. If the employee is receiving coverage that is more expensive than single coverage (such as family or self-plus-one coverage), the employer satisfies the 50% requirement with respect to the employee if the employer pays an amount of the premium for such coverage that is no less than 50% of the premium for single coverage for that employee (even if it is less than 50% of the premium for the coverage the employee is actually receiving).