



SITZMANN ■ MORRIS ■ LAVIS

TO: Clients of Sitzmann Morris & Lavis Inc.

RE: Small Employer Health Care Tax Credit

Included in the health care reform law is a provision that makes available tax credits for qualified small employers that provide health coverage to their employees. On May 19th, the IRS published IRS Notice 2010-44 providing guidance on this provision. We are attaching the notice for your reference. Following are the highlights.

Key Provisions:

Eligibility:

- 1) Employer must have fewer than 25 full-time equivalent employees;
- 2) Average annual wages must be less than \$50,000; and
- 3) Employer must pay at least 50% of the employee's premiums. .

Employees counted:

All employees under a single employer are counted. That means all employees under a controlled group or an affiliated service group are counted.

Seasonal workers are not counted *unless* they work on more than 120 days during the taxable year.

Sole proprietors, partners in a partnership, 2% or greater shareholders in an S Corp, and 5% or greater owners of other businesses are not counted.

For further details and examples of calculating the number of FTE equivalents see section "D. Determining the Number of an Employer's FTEs," beginning on page 6 of the attached.

Calculating Hours of Service:

- 1) Each hour they perform work during the taxable year; and
- 2) Each hour on paid vacation, holiday, sick time, and other paid leaves of absence.

The employer can either use actual hours worked, a days-worked equivalency, or a weeks-worked equivalency. For details and examples of all of these calculation methods please see section "C. Determining the Number of Hours of Service Worked" beginning on page 4 of the attached notice.

Calculating Average Annual Wages:

Divide the total wages paid for the hours of service by the number of FTEs for the year. For examples see section “E. Determining the Employer’s Average Annual Wages,” beginning on page 7 of the attached.

Premiums Included:

Premiums paid for health insurance coverage are included. Health insurance coverage consists of medical care (direct, through insurance or reimbursement); dental, vision, long-term care, nursing home care, home health care, community-based care; coverage for a specified disease or illness; hospital indemnity and certain supplemental coverage. For examples, see page 10 of the attached.

It does not include: coverage only for accident, or disability income insurance; worker’s compensation; general liability; coverage for on-site medical clinics.

The 50% threshold must be met for each separate line of coverage. For example, if the employer only pays 40% of premium for vision then no credit can be taken for the vision premium. It also must be met for each level of coverage – employee or family coverage.

Calculating the Credit:

The maximum credit is 35% of eligible premium payments. For a tax-exempt employer, the maximum credit is 25%. The amount of premium an employer can take as a credit is capped by the average premium for the small group market in the employer’s State. The IRS published Revenue Ruling 2010-13 containing a chart of the average premiums by state. <http://www.irs.gov/pub/irs-drop/rr-10-13.pdf> For California, EE-only coverage is \$4,628 and family coverage is \$10,957.

The credit is phased out gradually beginning with more than 10 FTEs or average annual wages greater than \$25,000. It goes to zero at either 25 FTEs or \$50,000.

Examples of calculating the credit begin on page 11 of the attached.

Transition Relief for 2010 Tax Year:

An employer will meet the premium requirement if it pays at least 50% of the premium for single coverage for each employee receiving single coverage, and if the employer offers dependent coverage, if it pays an amount for each employee receiving the more expensive coverage that is no less than 50% of the premium for single coverage. In other words, the employer is not required to pay 50% of the employee + dependent premium cost. This is only for the 2010 tax year.

How to Claim the Credit:

The credit is claimed on the employer’s annual income tax return. The credit is only used to reduce your income. If the credit amount is greater than your profit you will not receive a refund for the difference. For a tax-exempt employer, the IRS will provide further

information. It is anticipated that tax-exempt employers will be able to reduce their quarterly payroll taxes, much like the COBRA subsidy credits are taken.

Effective dates:

The tax credit is available beginning with the 2010 tax year.

What's Next:

Employers should have received a postcard from the IRS with instructions on how to determine if you are eligible. Use this IRS link to find out if you qualify, to see additional examples and view their FAQ pages. <http://www.irs.gov/newsroom/article/0,,id=220809,00.html?portlet=6>

Please contact your SML Account Team if you have any questions.

Part III - Administrative, Procedural, and Miscellaneous

Section 45R – Tax Credit for Employee Health Insurance Expenses of Small Employers

Notice 2010-44

I. PURPOSE AND BACKGROUND

Section 45R of the Internal Revenue Code (Code) offers a tax credit to certain small employers that provide health insurance coverage to their employees. It is effective for taxable years beginning in 2010. Both taxable employers and employers that are organizations described in section 501(c) that are exempt from tax under section 501(a) (tax-exempt employers) may be eligible for the section 45R credit. Employers that satisfy the requirements for the credit are referred to in this notice as “eligible small employers.”

Section 45R was added to the Code by section 1421 of the Patient Protection and Affordable Care Act (Affordable Care Act), enacted March 23, 2010, Pub. L. No. 111-148. This notice provides guidance on section 45R as in effect for taxable years beginning before January 1, 2014, and also includes transition relief for taxable years beginning in 2010 with respect to the requirements for a qualifying arrangement under section 45R.

II. EMPLOYERS ELIGIBLE FOR THE CREDIT

A. Overview of Requirements for Eligibility

In order to be an eligible small employer, (1) the employer must have fewer than 25 full-time equivalent employees (FTEs) for the taxable 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 maintain a “qualifying arrangement.”¹ A qualifying arrangement is an arrangement under which the employer pays premiums for each employee enrolled in health insurance 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 (but see section V of this notice for transition relief for taxable years beginning in 2010 with respect to the requirements for a qualifying arrangement). An employer that is an agency or instrumentality of the federal government, or of a State, local or Indian tribal government, is not an eligible small employer for purposes of section 45R unless it is an organization described in section 501(c) that is exempt from tax under section 501(a).

The following steps must be followed to determine whether an employer is eligible for a credit under section 45R:

1. Determine the employees who are taken into account for purposes of the credit.
2. Determine the number of hours of service performed by those employees.
3. Calculate the number of the employer’s FTEs.
4. Determine the average annual wages paid per FTE.
5. Determine the premiums paid by the employer that are taken into account for purposes of the credit. Specifically, the premiums must be paid by an employer under a qualifying arrangement and must be paid for health insurance that meets the requirements of section 45R.

¹ Although the term “eligible small employer” is defined in section 45R(d)(1) to include employers with “no more than” 25 FTEs and average annual wages that “do not exceed” \$50,000, the phaseout of the credit amount under section 45R(c) operates in such a way that an employer with exactly 25 FTEs or with average annual wages exactly equal to \$50,000 is not in fact eligible for the credit.

The remainder of this section II explains the steps involved in determining whether an employer is eligible for the credit. Section III of this notice explains how to calculate the credit, and section IV explains how to claim the credit. Finally, section V provides transition relief for taxable years beginning in 2010 with respect to certain requirements for qualifying arrangements.

B. Determining the Employees Taken into Account

In general, employees who perform services for the employer during the taxable year are taken into account in determining the employer's FTEs, average wages, and premiums paid, with certain individuals excluded and with employees of certain related employers included. This section describes these rules.

Partners in a business and certain owners are not taken into account as employees for purposes of section 45R. Specifically, sole proprietors, partners in a partnership, shareholders owning more than two percent of an S corporation, and any owners of more than five percent of other businesses are not taken into account as employees for purposes of the credit. Family members of these owners and partners are also not taken into account as employees. For purposes of section 45R, 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. Finally, any other member of the household of these owners and partners who qualifies as a dependent under section 152(d)(2)(H) is not taken into account as an employee for purposes of section 45R.

Accordingly, the wages and hours of these business owners and partners, and of their family members and dependent members of their household, are disregarded in determining FTEs and average annual wages, and the premiums paid on their behalf are not counted in determining the amount of the section 45R credit.

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 taxable year, although premiums paid on their behalf may be counted in determining the amount of the section 45R credit.

All employers treated as a single employer under section 414(b), (c), (m) or (o) are treated as a single employer for purposes of section 45R. Thus, all employees of a controlled group under section 414(b) or (c), or an affiliated service group under section 414(m) (except employees not taken into account as described above), and all wages paid to, and premiums paid for, employees by the members of the controlled group or affiliated service group (except employees not taken into account as described above), are taken into account in determining whether any member of the controlled group or affiliated service group is an eligible small employer.

C. Determining the Number of Hours of Service Worked by Employees for the Taxable Year

An employee's hours of service for a year include the following: (1) each hour for which an employee is paid, or entitled to payment, for the performance of duties for the employer during the employer's taxable year; and (2) each hour for which an employee is paid, or entitled to payment, by the employer on account of a period of time during which no duties are performed due to vacation, holiday, illness, incapacity (including

disability), layoff, jury duty, military duty or leave of absence (except that no more than 160 hours of service are required to be counted for an employee on account of any single continuous period during which the employee performs no duties).

In calculating the total number of hours of service which must be taken into account for an employee for the year, the employer may use any of the following methods: (1) determine actual hours of service from records of hours worked and hours for which payment is made or due (payment is made or due for vacation, holiday, illness, incapacity, etc., as described above); (2) use a days-worked equivalency whereby the employee is credited with 8 hours of service for each day for which the employee would be required to be credited with at least one hour of service under rule (1) or (2) in the preceding paragraph; or (3) use a weeks-worked equivalency whereby the employee is credited with 40 hours of service for each week for which the employee would be required to be credited with at least one hour of service under rule (1) or (2) in the preceding paragraph.

Examples. In all of the examples in this notice, none of the employees is an owner, partner in a business or otherwise excluded from being taken into account under section 45R.

Example 1 – Counting hours of service by hours actually worked or for which payment is made or due. (i) For the 2010 taxable year, an employer's payroll records indicate that Employee A worked 2,000 hours and was paid for an additional 80 hours on account of vacation, holiday and illness. The employer counts hours actually worked.

(ii) Under this method of counting hours, Employee A must be credited with 2,080 hours of service (2,000 hours worked and 80 hours for which payment was made or due).

Example 2 – Counting hours of service under weeks-worked equivalency. (i) For the 2010 taxable year, Employee B worked 49 weeks, took 2 weeks of vacation with

pay, and took 1 week of leave without pay. The employer uses the weeks-worked equivalency.

(ii) Under this method of counting hours, Employee B must be credited with 2,040 hours of service (51 weeks multiplied by 40 hours per week).

D. Determining the Number of an Employer's FTEs

The number of an employer's FTEs is determined by dividing (1) the total hours of service, determined in accordance with section II.C of this notice, credited during the year to employees taken into account under section II.B of this notice (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. In some circumstances, an employer with 25 or more employees may 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.

Example 3 – Determining the number of FTEs. (i) For the 2010 taxable 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 does not use an equivalency method to determine hours of service for any of these employees.

(ii) The employer's FTEs would be calculated as follows:

- (1) Total hours of service not exceeding 2,080 per employee is the sum of:
 - a. 10,400 hours of service for the 5 employees paid for 2,080 hours each (5 x 2,080)
 - b. 3,120 hours of service for the 3 employees paid for 1,040 hours each (3 x 1,040), and
 - c. 2,080 hours of service for the 1 employee paid for 2,300 hours (lesser of 2,300 and 2,080).
 - d. The sum of a, b and c equals 15,600 hours of service.
- (2) FTEs equal 7 (15,600 divided by 2,080 = 7.5, rounded to the next lowest whole number).

Example 4 – Determining the number of FTEs: (i) For the 2010 taxable year, an employer has 26 FTEs with average annual wages of \$23,000 per FTE. Only 20 of the employer's employees are enrolled in the employer's health insurance plan.

(ii) The hours of service and wages of all employees are taken into consideration in determining whether the employer is an eligible small employer for purposes of the credit. Because the employer does not have fewer than 25 FTEs for the taxable year, the employer is not an eligible small employer for purposes of the credit.

E. Determining the Employer's Average Annual Wages for the Taxable Year

The average annual wages paid by an employer for a taxable year is determined by dividing (1) the total wages paid by the employer during the employer's taxable year to employees taken into account under section II.B of this notice 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 purposes of determining the employer's average annual wages for the taxable year, only wages that are paid for hours of service determined under section II.C of this notice are taken into account. Wages for this purpose means wages as defined under section 3121(a) for purposes of the Federal Insurance Contributions Act (FICA), determined without regard to the wage base limitation under section 3121(a)(1).

Example 5 – Determining the amount of average annual wages. (i) For the 2010 taxable year, an employer pays \$224,000 in wages and has 10 FTEs.

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

F. Premium Payments by the Employer for the Taxable Year

Only premiums paid by the employer for health insurance coverage are counted in calculating the credit. If an employer pays only a portion of the premiums for the coverage provided to employees (with employees paying the rest), only the portion paid by the employer is taken into account. For example, if an employer pays 80 percent of the premiums for employees' coverage (with employees paying the other 20 percent),

the 80 percent paid by the employer is taken into account in calculating the credit. For purposes of this credit, any premium paid pursuant to a salary reduction arrangement under a section 125 cafeteria plan is not treated as paid by the employer. In calculating the credit for a taxable year beginning in 2010, an employer may count all premiums paid by the employer in the 2010 tax year, including premiums that were paid in the 2010 tax year before the Affordable Care Act was enacted.

G. Premiums for Health Insurance Coverage under a Qualifying Arrangement

An employer's premium payments are not taken into account for purposes of the section 45R credit unless they are paid for health insurance coverage under a qualifying arrangement. As noted in section II.A of this notice, a qualifying arrangement is an arrangement under which the employer pays premiums for each employee enrolled in health insurance 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 (but see section V of this notice for transition relief for taxable years beginning in 2010 with respect to certain requirements for a qualifying arrangement).

For years prior to 2014, health insurance coverage for purposes of the credit means benefits consisting of medical care (provided directly, through insurance or reimbursement, or otherwise) under any hospital or medical service policy or certificate, hospital or medical service plan contract, or health maintenance organization contract offered by a health insurance issuer. See section 9832(b)(1). Health insurance coverage for purposes of the section 45R credit also includes the following plans described in section 9832(c)(2), (3) and (4): limited scope dental or vision; long-term care, nursing home care, home health care, community-based care, or any combination

thereof; coverage only for a specified disease or illness; hospital indemnity or other fixed indemnity insurance; and Medicare supplemental health insurance; certain other supplemental coverage, and similar supplemental coverage provided to coverage under a group health plan. Health insurance coverage does not include the benefits listed in section 9832(c)(1).² If an eligible small employer offers any of the plans described in section 9832(b)(1) or 9832(c)(2), (3) or (4), the premiums paid by the employer for that plan can be counted in calculating the credit if the premiums are paid under a qualifying arrangement.

Different types of health insurance plans are not aggregated for purposes of meeting the qualifying arrangement requirement. So, for example, if an employer offers a major medical insurance plan and a stand-alone vision plan, the employer must separately satisfy the requirements for a qualifying arrangement with respect to each type of coverage.

The amount of an employer's premium payments that are taken into account in calculating the credit is limited to 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. For example, if an eligible small employer pays 80 percent of the premiums for coverage provided to employees (and employees pay the other 20 percent), the premiums taken into account for purposes of the credit are the

² Section 9832(c)(1) includes the following benefits: (A) coverage only for accident, or disability income insurance, or any combination thereof; (B) coverage issued as a supplement to liability insurance; (C) liability insurance, including general liability insurance and automobile liability insurance; (D) worker's compensation or similar insurance; (E) automobile medical payment insurance; (F) credit-only insurance; (G) coverage for on-site medical clinics; and (H) other similar insurance coverage, specified in regulations, under which benefits for medical care are secondary or incidental to other insurance benefits.

lesser of 80 percent of the total actual premiums paid or 80 percent of the premiums that would have been paid for the coverage if the average premium for the small group market in the State (or an area within the State) were substituted for the actual premium. See Rev. Rul. 2010-13, 2010-21 IRB 691, for the average premium for the small group market in a State for the 2010 taxable year.

The average premium for the small group market in the State does not apply separately to each type of coverage described in section 9832(b)(1), (c)(2), (c)(3) and (c)(4), but rather provides an overall cap for all health insurance coverage provided by an eligible small employer.

Example 6 – Determining amount of premium payments for purposes of the credit. (i) For the 2010 taxable year, an eligible small employer offers a health insurance plan with single and family coverage. Employer has 9 FTEs with average annual wages of \$23,000 per FTE. Four employees are enrolled in single coverage and 5 are enrolled in family coverage.

(ii) The employer pays 50% of the premiums for all employees enrolled in single coverage and 50% of the premiums for all employees enrolled in family coverage (and the employee is responsible for the remainder in each case). The premiums are \$4,000 a year for single coverage and \$10,000 a year for family coverage. The average premium for the small group market in employer's State is \$5,000 for single coverage and \$12,000 for family coverage.

(iii) The employer's premium payments for each FTE (\$2,000 for single coverage and \$5,000 for family coverage) do not exceed 50% of the average premium for the small group market in employer's State (\$2,500 for single coverage and \$6,000 for family coverage).

(iv) Thus, the amount of premiums paid by the employer for purposes of computing the credit equals \$33,000 ((4 x \$2,000) plus (5 x \$5,000)).

Example 7 – Premium payments exceeding average premium for small group market. (i) Same facts as Example 6, except that the premiums are \$6,000 for single coverage and \$14,000 for family coverage.

(ii) The employer's premium payments for each employee (\$3,000 for single coverage and \$7,000 for family coverage) exceed 50% of the average premium for the

small group market in the employer's State (\$2,500 for single coverage and \$6,000 for family coverage).

(iii) Thus, the amount of premiums paid by the employer for purposes of computing the credit equals \$40,000 ((4 x \$2,500) plus (5 x \$6,000)).

Example 8 – Offering health insurance plan and dental plan. (i) For the 2010 taxable year, an eligible small employer offers a major medical plan and a dental plan. The employer pays 50% of the premium cost for single coverage for all employees enrolled in the major medical plan and 50% of the premium cost for single coverage for all employees enrolled in the dental plan.

(ii) For purposes of calculating the credit, the employer can take into consideration the premiums paid by the employer for both the major medical plan and the dental plan, but only up to 50% of the amount of the average premium for single coverage for the small group market in the employer's State.

Example 9 – Meeting qualifying arrangement requirement. (i) Same facts as Example 8, except that the employer pays 40% of the premium cost for single coverage for all employees enrolled in the dental plan.

(ii) For purposes of calculating the credit, the employer can take into consideration only the premiums paid by the employer for the major medical plan, and only up to 50% of the amount of the average premium for single coverage for the small group market in the employer's State. The employer cannot take into consideration premiums paid for the dental plan.

III. CALCULATING THE CREDIT

A. In General

The following steps are followed to calculate the section 45R credit:

1. Calculate the maximum amount of the credit (section III.B);
2. Reduce the maximum credit in step 1 in accordance with the phaseout rule

(section III.C), if necessary; and

3. For employers receiving a State credit or subsidy for health insurance, determine the employer's actual premium payment (section III.D).

B. Maximum Credit

For taxable years beginning in 2010 through 2013, the maximum credit is 35 percent of a taxable eligible small employer's premium payments taken into account for purposes of the credit. For a tax-exempt eligible small employer for those years, the maximum credit is 25 percent of the employer's premium payments taken into account for purposes of the credit. However, for a tax-exempt employer, the amount of the credit cannot exceed the total amount of income tax under section 3402 and Medicare (i.e., Hospital Insurance) tax under section 3101(b) that the employer is required to withhold from employees' wages for the year and the employer share of Medicare tax under section 3111(b) on employees' wages for the year.

C. Credit Phaseout

The credit phases out gradually (but not below zero) for eligible small employers if the number of FTEs exceeds 10 or if the average annual wages exceed \$25,000. 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 total reduction is the sum of the two reductions. This may reduce the credit to zero for some employers with fewer than 25 FTEs and average annual wages of less than \$50,000.

Example 10 – Calculating the maximum credit for a taxable eligible small employer. (i) For the 2010 taxable year, a taxable eligible small employer has 9 FTEs with average annual wages of \$23,000 per FTE. The employer pays \$72,000 in health insurance 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.

(ii) The credit for 2010 equals \$25,200 (35% x \$72,000).

Example 11 – Calculating the maximum credit for a tax-exempt eligible small employer. (i) For the 2010 taxable year, a tax-exempt eligible small employer has 10 FTEs with average annual wages of \$21,000 per FTE. The employer pays \$80,000 in health insurance premiums for its 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.

(ii) The credit is calculated as follows:

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

Example 12 – Calculating the credit phase-out if the number of FTEs exceeds 10 or average annual wages exceed \$25,000. (i) For the 2010 taxable year, a taxable eligible small employer has 12 FTEs and average annual wages of \$30,000. The employer pays \$96,000 in health insurance premiums for its 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.

(ii) The credit is calculated as follows:

- (1) Initial amount of credit determined before any reduction: (35% x \$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 equals \$22,400 ($\$33,600 - \$11,200$).

D. State Credits and State Subsidies for Health Insurance

Some States offer tax credits to certain small employers that provide health insurance to their employees. Some of these are refundable credits and others are

nonrefundable credits. In addition, some States offer premium subsidy programs for certain small employers under which the State makes a payment equal to a portion of the employees' health insurance premiums under the employer-provided health insurance plan. Generally, the State pays this premium subsidy either directly to the employer or to the employer's insurance company (or another entity licensed under State law to engage in the business of insurance). If the employer is entitled to a State tax credit (whether refundable or nonrefundable) or a premium subsidy that is paid directly to the employer, the premium payment made by the employer is not reduced by the credit or subsidy for purposes of determining whether the employer has satisfied the "qualifying arrangement" requirement to pay an amount equal to a uniform percentage (not less than 50 percent) of the premium cost. Also, except as described below in this section III.D, the maximum amount of the section 45R credit is not reduced by reason of a State tax credit (whether refundable or nonrefundable) or by reason of payments by a State directly to an employer.

Generally, if a State makes payments directly to an insurance company (or another entity licensed under State law to engage in the business of insurance) to pay a portion of the premium for coverage of an employee under employer-provided health insurance (State direct payments), the State is treated as making these payments on behalf of the employer for purposes of determining whether the employer has satisfied the "qualifying arrangement" requirement to pay an amount equal to a uniform percentage (not less than 50 percent) of the premium cost of coverage. Also, except as described below in this section III.D, these premium payments by the State are treated as an employer contribution under section 45R for purposes of calculating the credit.

Although State tax credits and payments to an employer generally do not reduce an employer's otherwise applicable credit under section 45R, and although State direct payments are generally treated as paid on behalf of an employer, in no event may the amount of the section 45R credit exceed the amount of the employer's net premium payments. In the case of a State tax credit for an employer or a State subsidy paid directly to an employer, the employer's net premium payments are calculated by subtracting the State tax credit or subsidy from the employer's actual premium payments. In the case of a State payment directly to an insurance company (or another entity licensed under State law to engage in the business of insurance), the employer's net premium payments are the employer's actual premium payments.

If a State-administered program (such as Medicaid or another program that makes payments directly to a health care provider or insurance company on behalf of individuals and their families who meet certain eligibility guidelines) makes payments that are not contingent on the maintenance of an employer-provided group health plan, those payments are not taken into account in determining the credit under section 45R.

Example 13 - State premium subsidy paid directly to employer. (i) Employer's State provides a health insurance premium subsidy of up to 40% of the health insurance premiums for each eligible employee. The State pays the subsidy directly to the employer.

(ii) Employer has one employee, Employee D. Employee D's health insurance premiums are \$100 per month and are paid as follows: \$80 by the employer and \$20 by Employee D through salary reductions to a cafeteria plan. The State pays Employer \$40 per month as a subsidy for Employer's payment of insurance premiums on behalf of Employee D. Employer is otherwise an eligible small employer that meets the requirements for the section 45R credit.

(iii) For purposes of the requirements for a qualifying arrangement, and for purposes of calculating the amount of the section 45R credit, the amount of premiums paid by the employer is \$80 per month (the premium payment by the Employer without regard to the subsidy from the State).

Example 14 - State premium subsidy paid directly to employer's insurance company. (i) Employer's State provides a health insurance premium subsidy of up to 50% for each eligible employee. The State pays the premium directly to the employer's health insurance provider.

(ii) Employer has one employee, Employee E. Employee E is enrolled in single coverage under Employer's health insurance plan.

(iii) Employee E's health insurance premiums are \$100 per month and are paid as follows: \$30 by the employer; \$50 by the State and \$20 by the employee. The State pays the \$50 per month directly to the insurance company and the insurance company bills the employer for the employer and employee's share, which equal \$50 per month. Employer is otherwise an eligible small employer that meets the requirements for the section 45R credit.

(iv) For purposes of the requirements for a qualifying arrangement, and for purposes of calculating the amount of the section 45R credit, the amount of premiums paid by the employer is \$80 per month (the sum of the employer's payment and the State's payment).

Example 15 - Credit limited by employer's net premium payment. (i) Employer's State provides a health insurance premium subsidy of up to 50% for each eligible employee. The State pays the premium directly to the employer's health insurance provider. Employer has one employee, Employee F. Employee F is enrolled in single coverage under Employer's health insurance plan. Employee F's health insurance premiums are \$100 per month and are paid as follows: \$20 by the employer; \$50 by the State and \$30 by the employee. The State pays the \$50 per month directly to the insurance company and the insurance company bills the employer for the employer's and employee's shares, which total \$50 per month. Employer is otherwise an eligible small employer that meets the requirements for the section 45R credit.

(ii) The amount of premiums paid by the employer for purposes of determining whether the employer meets the qualifying arrangement requirement (the sum of the employer's payment and the State's payment) is \$70 per month, which is more than 50% of the \$100 monthly premium payment. The amount of the premium for calculating the maximum section 45R credit is also \$70 per month. The maximum credit is \$24.50 ($\$70 \times 35\%$).

(iii) The employer's net premium payment is \$20 (the amount actually paid by the employer excluding the State subsidy). After applying the limit for the employer's net premium payment, the section 45R credit is \$20 per month, (the lesser of \$24.50 or \$20).

IV. CLAIMING THE CREDIT AND EFFECT ON ESTIMATED TAX, ALTERNATIVE MINIMUM TAX AND DEDUCTIONS

The section 45R credit is claimed on an eligible small employer's annual income tax return and offsets an employer's actual tax liability for the year. For a tax-exempt eligible small employer, the IRS will provide further information on how to claim the credit. For an eligible small employer that is not a tax-exempt employer, the credit is a general business credit and, thus, any unused credit amount can be carried back one year and carried forward 20 years (however, because an unused credit amount cannot be carried back to a year before the effective date of the credit, any unused credit amounts for taxable years beginning in 2010 can only be carried forward). For a tax-exempt eligible small 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 tax-exempt eligible small employer's total income tax withholding and Medicare tax liability for the year).

The credit can be reflected in determining estimated tax payments for the year in which the credit applies in accordance with regular estimated tax rules. The credit can also be used to offset an employer's alternative minimum tax (AMT) liability for the year, subject to certain limitations based on the amount of an employer's regular tax liability, AMT liability and other allowable credits. See section 38(c)(1), as modified by section 38(c)(4)(B)(vi). However, because the credit applies against income tax, an employer may not reduce employment tax (i.e., withheld income tax, social security tax under sections 3101(a) and 3111(a), and Medicare tax) deposits and payments during the year in anticipation of the credit. Finally, no deduction is allowed for the employer under section 162 for that portion of the health insurance premiums which is equal to the amount of the section 45R credit.

V. TRANSITION RELIEF FOR TAXABLE YEARS BEGINNING IN 2010

Because the section 45R credit applies to taxable years beginning in 2010 (including the period in 2010 before enactment of the Affordable Care Act), an employer that satisfies the requirements for the transition relief in this section V will be deemed to satisfy the requirement for a qualifying arrangement that the employer pay a uniform percentage (not less than 50 percent) of the premium cost of the health insurance coverage (uniformity requirement). Specifically, for taxable years beginning in 2010, an employer that pays an amount equal to at least 50 percent of the premium for single (employee-only) coverage for each employee enrolled in coverage offered to employees by the employer will be deemed to satisfy the uniformity requirement for a qualifying arrangement, even if the employer does not pay the same percentage of the premium for each such employee. Thus, an employer will be deemed to satisfy the uniformity requirement for a qualifying arrangement if it pays at least 50 percent of the premium for single coverage for each employee receiving single coverage, and, if the employer offers coverage that is more expensive than single coverage (such as family or self-plus-one coverage), if it pays an amount for each employee receiving that more expensive coverage that is no less than 50 percent of the premium for single coverage for that employee (even if it is less than 50 percent of the premium for the more expensive coverage the employee is actually receiving).

Example 16 -Transition relief rule for a qualifying arrangement. (i) For the 2010 taxable year, an eligible small employer has 9 FTEs with average annual wages of \$23,000 per FTE. Six employees are enrolled in single coverage and 3 employees are enrolled in family coverage.

(ii) The premiums are \$8,000 for single coverage for the year and \$14,000 for family coverage for the year (which do not exceed the average premiums for the small group market in the employer's State). The employer pays 50% of the premium for

single coverage for each employee enrolled in single or family coverage (50% x \$8,000 = \$4,000 for each employee).

(iii) Thus, the employer pays \$4,000 of the premium for each of the 6 employees enrolled in single coverage and \$4,000 of the premium for each of the 3 employees enrolled in family coverage.

(iv) The employer is deemed to satisfy the uniformity requirement for a qualifying arrangement under the transition relief rule.

Example 17 – Arrangement that does not satisfy requirement for transition relief.

(i) Same facts as Example 16, except that the employer pays 50% of the premium for employees enrolled in single coverage (\$4,000 for each of those 6 employees) but pays none of the premium for employees enrolled in family coverage.

(ii) The employer does not satisfy the uniformity requirement for a qualifying arrangement.

VI. EFFECTIVE DATE

Section 45R is effective for taxable years beginning after December 31, 2009.

REQUEST FOR COMMENTS

The IRS and Treasury intend to issue future guidance that will address additional issues under section 45R, including the application of the uniformity requirement and the 50-percent requirement for taxable years beginning after 2010. Comments are requested on issues that should be addressed in that future guidance.

Comments should be submitted on or before September 1, 2010, and should include a reference to Notice 2010-44. Send submissions to CC:PA:LPD:PR (Notice 2010-44), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered **Monday through Friday** between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (Notice 2010-44), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20044, or sent electronically, via the following e-mail address:

Notice.comments@irscounsel.treas.gov. Please include "Notice 2010-44" in the subject line of any electronic communication. All material submitted will be available for public inspection and copying.

DRAFTING INFORMATION

The principal author of this notice is Mireille Khoury of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice contact Ms. Khoury at (202) 622-6080 (not a toll-free call).