AFFORDABLE CARE ACT TAX OVERVIEW

SMALL EMPLOYERS

Stay on the good side of changing requirements and opportunities

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Employers face a variety of tax-related compliance requirements under the Affordable Care Act (ACA). As a small employer, you need not comply with one of the most notable provisions — shared responsibility, commonly referred to as "play or pay" — or fear the related penalties. But you still must consider carefully whether the ACA provides other reasons for you to start offering health care coverage or to change or eliminate coverage. You also may be eligible for a tax credit.

Here's a closer look at some key tax-related ACA provisions and IRS guidance that are of particular interest to small employers. Additional provisions and details may apply, so consult your tax and benefits advisors to determine exactly how your organization will be affected.

You *are* a small employer, right?

The play-or-pay provision doesn't *require* any employer, small or large, to provide health care coverage. Rather, in some cases, it imposes penalties on "large" employers that don't offer "minimum essential" coverage or that offer coverage that is "unaffordable" or that doesn't provide "minimum value."

The play-or-pay provision won't take effect for large employers until Jan. 1, 2015. In addition, some "transitional relief" will be available in 2015. Nonetheless, employers must determine annually, based on their employees' actual hours of service, whether they'll be considered a large employer for the next year. So, even if you've already determined that you're currently a small employer, it's important to keep an eye on your workforce so you're aware if any changes occur that could cause you to become a large employer for ACA purposes.

Calculating full-time employees

Under the ACA, a large employer is one with 50 or more full-time employees. Under IRS final regulations issued in February 2014, however, qualifying employers with 50 to 99 full-time employees won't be subject to the play-or-pay provision until 2016. To qualify for this transitional relief, the employer must:

- Maintain its workforce size and aggregate hours of service,
- Maintain the health care coverage it offered as of Feb. 9, 2014, and
- Certify that it meets the requirements.

When counting full-time employees, part-timers must be factored into that number by calculating full-time equivalent employees (FTEs) and adding that figure to the total number of actual full-time employees.

A full-time employee generally is someone employed on average at least 30 hours per week or 130 hours in a calendar month. Calculating FTEs for a given calendar month requires totaling the hours of service for all part-time employees and dividing that figure by 120.

For hourly employees, the hours should be calculated based on records of hours worked and hours for which payment is made or due for vacation, holiday, illness, incapacity (including disability), layoff, jury duty, military duty or leave of absence.

For salaried employees, there are three methods of determining the hours:

1. The same method used for hourly employees,
2. A days-worked equivalency method (each worker is credited with eight hours for each day worked), or
3. A weeks-worked equivalency method (each worker is credited with 40 hours for each week worked).

You can apply different methods for different classifications of nonhourly employees, so long as the classifications are "reasonable and consistently applied."

Seasonal employees and controlled entities

Under certain circumstances, hiring seasonal workers could push a small employer over the edge and trigger the play-or-pay provision. This could be the case if you're close to the threshold of being considered a large employer. Even if you

aren't otherwise close to the threshold, you could be at risk if your seasonal employees work a substantial number of hours.

Fortunately, if your company meets the full-time employee threshold for 120 days or fewer during a calendar year "solely due to seasonal workers," you won't be subject to the play-or-pay provision. Nonetheless, if your business typically hires seasonal help, you should discuss any potential risks with your financial and benefits advisors.

If your company controls multiple other entities, or is controlled by another entity, you may need to delve into the "controlled group" rules under the ACA. Generally, separate entities that are part of a controlled group will be treated as a single employer for play-or-pay purposes. Controlled groups can take various forms, such as parent-subsidiary, brother-sister or other combined groups. Contact your tax and benefits advisors for more information.

SHOP website delayed

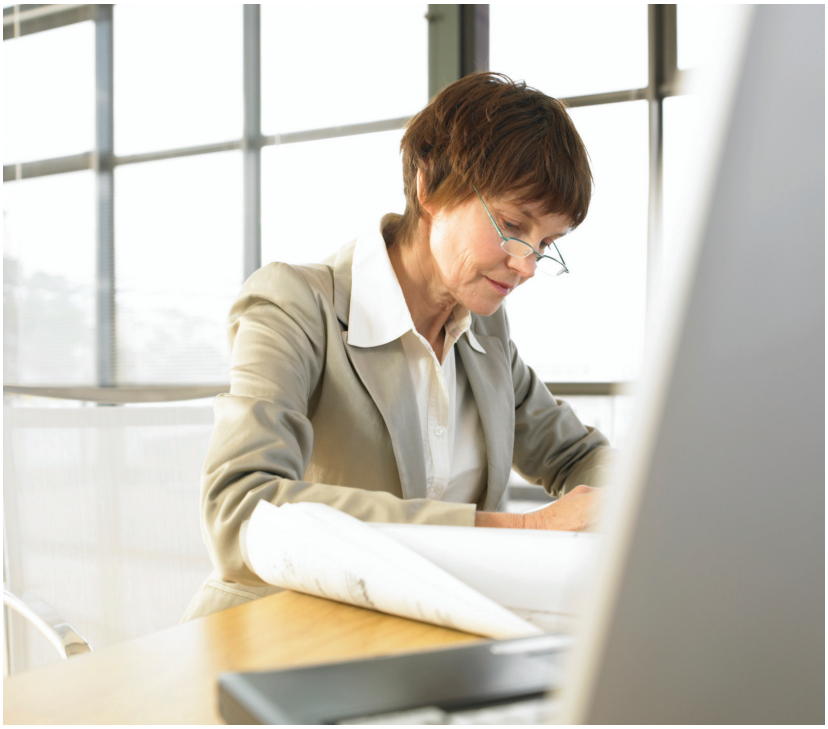
There's been no shortage of media coverage on the faults of the healthcare.gov website. For small businesses hoping to use it to find group coverage, the wait for full functionality shall continue. In late 2013, an official at the U.S. Department of Health and Human Services confirmed that the website for the Small Business Health Options Program (SHOP) would not be ready to go until November 20*14*. The federal government had hoped to launch the site on Oct. 1, 20*13*.

This delay affects only applying for SHOP coverage *online* through the *federal* website. Until the website is ready, to apply for SHOP coverage, paperwork generally must be submitted through a broker or agent. You can still go to healthcare.gov to research health care coverage and find other pertinent information.

Changes to the health care coverage credit

As you're probably aware, a credit for providing health care coverage has been available to small employers for the last several years. Through 2013, the maximum tax credit was 35% of premiums paid by qualified small business employers (25% of premiums for small tax-exempt organizations).

There are some important changes to the tax credit for 2014. In late 2013, the IRS issued proposed regulations updating and fine-tuning the original Section 45R rules governing the credit. More important, the tax break becomes more valuable to eligible employers starting in 2014 — but some new limitations also take effect.



Qualification requirements

To qualify for the full tax credit, employers cannot have more than 10 full-time employees or the equivalent with part-timers factored in. This is calculated differently than for the play-or-pay provision.

To determine the number of FTEs for purposes of claiming the credit, you calculate the total number of employee hours for the year and then divide that number by 2,080. The result is then rounded down, though not below zero. Please note that there are various factors that may complicate the calculation for your specific circumstances. These include hiring new employees during the year and starting an entirely new business.

The tax credit is reduced if an employer has more than 10 but fewer than 25 FTEs or pays average annual wages of more than $25,000 but less than $50,000. And the credit is unavailable for employers with 25 or more FTEs and those whose aggregate employee wages average $50,000 or more. (This salary cap will be inflation-adjusted annually.) Also, the percentage of the health plan's value paid by the employer must be the same for all employees. (Different tax credit formulas apply to tax-exempt organizations.)

Sole proprietors, partners in a partnership and shareholders who own more than 2% of an S corporation's stock are not counted as "employees" for purposes of the size or average wage calculations. The same applies to family members working in the business.

Up until now, in order to claim a tax credit, small employers could find a suitable health plan any way they chose. Starting this year, the rules have changed. The proposed IRS regulations state that small employers will qualify for tax credits only if they choose SHOP coverage. The Treasury Department announced, however, that employers without access to SHOP coverage will be eligible for the credit as long as they provide coverage that meets the guidelines of a SHOP plan.

CASE STUDY **Calculating the health care coverage credit**

For the 2014 tax year, Acme offers its employees a group health plan with single and family coverage and pays 50% of the premiums. Acme has 10 full-time equivalent employees with average annual wages of $23,000. Six employees are enrolled in single coverage and four are enrolled in family coverage. Total premiums are $4,000 a year for single coverage and $10,000 a year for family coverage.

Let's presume for illustrative purposes that the average premiums for the small group market in Acme's state are $5,000 and $12,000, respectively. Acme's premium payments ($2,000 for single coverage and $5,000 for family coverage) don't exceed 50% of these averages, so it computes the credit based on its actual premium payments of $32,000 (6 × $2,000 + 4 × $5,000). Acme's tax credit is $16,000 ($32,000 × 50%).

Determining the credit amount

The *maximum* credit, determined as a percentage of the business employer's contribution to the employee's health benefit (based on self-only coverage), has increased from 35% in 2013 to 50% in 2014. The maximum credit for eligible tax-exempt organizations has also increased from 25% to 35% in 2014.

The actual amount of the credit your company can claim is based on a complex formula. The first element is that the credit must be based on the lesser of:

- The amount you paid on employees' behalf, or
- What you would have paid if you'd used an average small group plan for your rating area.

In other words, if you offer a very generous health plan, you'll get the same tax benefit you'd receive for an "average" plan.

If you receive state tax credits for providing health benefits, they won't affect whether you satisfy the 50% minimum cost-sharing test. But they *will* impact the amount of the federal tax credit.

The cost-sharing test determines the amount the employer is required to pay for each employee, typically based on self-only coverage. Thus, if an employee opts for family coverage, the employer will be required to pay no less than 50% of the premium that the employee would have paid had he or she chosen self-only coverage. But there are various exceptions that could leave the employer obligated for an amount different from that calculated under the general rule.

Other components of the formula are the number of FTEs, average wages and possibly the phaseout calculations if you have more than 10 employees or average wages exceeding $25,000.

Two-year limit and other notes of interest

Beginning in 2014, the credit can be taken for only two years, which must be *consecutive* years. But, even if you claimed it for tax years *before* 2014, you can still claim the credit for two years beginning in 2014 or later (such as for 2014 and 2015 or for 2015 and 2016). This adds an element of strategic planning in that a business may want to refrain from taking the credit, even though eligible to do so, until it will provide the greatest benefit.

The credit, or a portion of it, can be carried back or forward if your tax liability for the year is lower than the credit amount. Transition rules allow you to be eligible for the tax credit for 2014 even if your plan year begins later than Jan. 1. (Note: The new regulations make it clear that you cannot create a new but identical business entity simply for the sake of allowing you to get around the two-year limit.)

Making tough choices

Small employers don't need to worry about suffering play-or-pay penalties for not providing sufficient coverage. But, with insurance premiums continuing to be expensive for many businesses, you'll still need to make the tough choice of whether to offer a group medical plan, subsidize your employees' health care on the Health Insurance Marketplace or cease offering any health care benefits at the peril of losing valuable staff members. Your tax and benefits advisors can help you sort out these tough choices.

Limited waiting period now applies

One notable health care act provision that took effect on Jan. 1, 2014, is a much shorter maximum waiting period for health care coverage. That is, when a new hire opts to participate in your health plan, this individual's coverage must begin within 90 days of his or her start date. The requirement is applicable to all qualifying employees and their dependents.

The waiting period should be calculated using all calendar days, including weekends and holidays. So, let's say you hire a new full-time staff member who starts work on July 1 of this year. His or her coverage must begin by Sept. 28.

New employees must receive "exchange notices"

One of the ACA provisions that *all* employers — whether small or large — had to begin complying with last year (as of Oct. 1, 2013) was providing all employees with "exchange notices." These communications were mandated to:

- Provide notification of the existence of the new Health Insurance Marketplace,
- Offer information explaining that employees may be eligible for a premium tax credit if they buy coverage via a Marketplace, and
- Warn employees that, if they do buy from the Marketplace, they may lose any employer contribution to any existing employer-provided health plan.

The notice is, however, required to be given only once — you don't need to provide it annually. So, assuming you

New, higher incentives kick in for employee wellness programs

Beginning on Jan. 1, 2014, employers that offer a qualifying, "health-contingent" wellness program may receive a maximum reward of 30% of the cost of its health coverage (up from 20% in 2013). And the maximum reward for the prevention and reduction of tobacco usage is 50%.

These ACA incentives are intended to encourage employers to establish formal programs to promote employee wellness. To meet the definition of "health-contingent," participants must meet specified, health-related objectives to obtain a reward, such as decreasing tobacco usage or lowering their cholesterol. Additional rules and restrictions apply.

complied last year, you don't need to send notices to all of your employees again this year.

But keep in mind that exchange notices are required to be provided to all *new* employees hired after Oct. 1, 2013, regardless of plan enrollment status (if applicable) or of part-time or full-time status. So if you've added staff recently, be sure to keep up with this obligation. The Department of Labor offers a sample notice on its website (dol.gov) for employers that offer health care coverage — search for "ebsa."

You don't need to provide separate exchange notices to dependents or other individuals who are now or may become eligible for coverage under your plan but who aren't employees. And you don't need to provide notices to individuals who are no longer employees, such as retirees or COBRA beneficiaries.

Additional Medicare tax withholding

Under the Federal Insurance Contributions Act (FICA), wages are subject to a 2.9% Medicare tax — 1.45% paid by the employers and 1.45% withheld from the employees' wages. Beginning last year, under the ACA, taxpayers with FICA wages over $200,000 per year ($250,000 for joint filers and $125,000 for married filing separately) had to pay an additional 0.9% Medicare tax on the excess earnings.

Unlike regular Medicare taxes, the additional Medicare tax *doesn't* include a corresponding employer portion. But employers *are* obligated to withhold the additional tax to the extent that an employee's wages exceed $200,000 in a calendar year.

Remember, the $200,000 amount doesn't include the employee's income from any other sources. Nor does it take into account his or her tax filing status. One consequence: You may be required to withhold the additional Medicare tax from wages paid to employees who aren't ultimately liable for the tax — for example, because their wages, together with those of their spouse, don't exceed the $250,000 threshold for joint filers.

An employee can't ask his or her employer to stop withholding the tax. Instead, if an employee ultimately doesn't owe the tax, he or she can claim a credit for the withheld tax on his or her income tax return for the year.

It's also possible that *no* additional Medicare tax will be withheld from employees who *are* liable for the tax. This could occur if the combined earnings of a married couple filing jointly exceed $250,000 but neither spouse's wages are more than $200,000 or if an individual has two jobs and neither job pays wages in excess of the threshold. Employees who anticipate additional Medicare tax liability can't request that you withhold additional amounts specifically for the tax. They can, however, use Form W-4 to request additional *income* tax withholding sufficient to cover their liability for the additional Medicare tax.

In November 2013, the IRS released final regulations regarding the additional Medicare tax and the employer withholding requirements. The only substantial change from the proposed regulations is that employers no longer have access to relief from payment liability for any additional Medicare tax that was required to be withheld but that they didn't withhold — unless the employer can provide evidence that the employee in question has paid the tax.

Amending FSA plans

Health care Flexible Spending Accounts (FSAs) allow employees to redirect pretax income to an employer-sponsored plan that pays, or reimburses them for, qualified medical expenses not covered by insurance. A maximum employee contribution limit of $2,500 went into effect in 2013. (Employers can set a *lower* limit, however.)

According to the IRS, the new limit applies on a plan year basis. Thus, non-calendar-year plans must comply for the plan year that started in 2013.

Employers that haven't yet done so must amend their plans and summary plan descriptions to reflect the $2,500 limit (or a lower one, if they wish) by Dec. 31, 2014, and institute measures to ensure employees don't elect contributions that exceed the limit. Note that there will continue to be *no* limit on employer contributions to FSAs.