January 10, 2011

The Small Business Health Care Tax Credit and United Methodist Churches

On December 2, 2010, the Internal Revenue Service (IRS) released its final guidance (Notice 2010-82) on the small business health care tax credit (Tax Credit) contained in the Patient Protection and Affordable Care Act (PPACA), for tax years 2010 to 2013. As written, PPACA limited the Tax Credit to costs relating to “health insurance coverage.” Thus, it was initially unclear as to whether small employers that participated in self-funded church plans were eligible for the Tax Credit. Notice 2010-82 specifically provides that local churches and small employers can qualify for the Tax Credit even if they obtain coverage through a self-funded church health care plan like HealthFlex or their annual conference health plan. The Church Alliance’s efforts to obtain recognition of self-funded church health care plans as “health insurance coverage” for purposes of the Tax Credit were successful. Small church employers with employees enrolled in HealthFlex or other self-funded annual conference health plans, or both, may be eligible for the Tax Credit beginning with the 2010 tax year (claimed in 2011). Local churches in insured annual conference plans or that purchase insurance in the small group market may also be eligible. The Tax Credit is available for small employers, including tax-exempt employers like local United Methodist churches, that employ 25 or fewer full-time equivalent employees (FTEs) and pay average wages of less than $50,000 per FTE.

If a small church employer employed 10 or fewer FTEs and paid annual average wages per FTE of $25,000 or less, the employer is entitled to a tax credit equal to 25% of the total premiums paid for a Qualifying Arrangement (limited in some cases to average statewide health insurance premiums). The percent credit decreases as the number of FTEs rises from 10 to 25 FTEs and the average annual wages increase from $25,000 to $50,000. There is no Tax Credit available to any employer who employs more than 25 FTEs and pays average annual wages in excess of $50,000 (see chart in Appendix).

Eligibility for the Tax Credit depends on whether:
1. the church has fewer than 25 full-time equivalent employees (FTEs);
2. the church pays average annual wages less than $50,000 (generally, not counting clergy wages); and
3. the church pays a uniform percentage of premiums under a Qualifying Arrangement (defined on page 2) for all covered employees that is at least 50% of the cost of single coverage (with a transition exception for 2010).

Counting the Number of FTEs
All employees—including former employees terminated during the year and employees who do not enroll in the health plan—are counted. There are three different acceptable methods of calculating the number of FTEs, based on:

- actual hours worked (with a maximum of 2,080 hours per employee, per year);
- days worked during the year; or
- weeks (or equivalent of weeks) worked during the year.

The number of FTEs is determined by dividing the total hours of service by 2,080 and rounding down to the nearest whole number.
Clergypersons who are considered common-law employees of a church employer for income tax and benefits purposes (i.e., they receive a Form W-2 from their church employer) are counted as employees. A clergyperson who is truly self-employed (and thus receives a Form 1099 from the church employer) is not counted in the FTE count. Other independent contractors (who receive a Form 1099) are not counted. Seasonal employees who work fewer than 120 days in a year are not counted.

**Computing Average Wages**

All wages paid to an employee, including wages for work in excess of 2,080 hours, are included in the annual average wage calculation. Average wages are rounded down to the nearest $1,000. Because ministers are considered self-employed for employment tax purposes (Social Security or FICA taxes), their wages are not included in the average wage calculation (even when they are included in the FTE count). This will have an effect of lowering the average wages for churches.

**Qualifying Arrangements**

A Qualifying Arrangement is a health insurance program as defined in the Public Health Service Act. Self-funded (self-insured) church health plans qualify as health insurance coverage for the purposes of the Tax Credit because of the Church Plan Parity and Entanglement Prevention Act of 1999.

The employer must make a contribution on behalf of each employee who is enrolled in health care coverage. This contribution cannot be less than 50% of the premium cost of single (employee-only) coverage under the church plan. If an employee is receiving coverage that is more expensive than single coverage (e.g., family coverage), the employer need only pay at least 50% of the premium for single coverage for that employee. The employer’s contribution must also be a uniform percentage of the premium cost for all covered employees. In order to satisfy the uniformity requirement, the church must pay the same percentage of the premium cost for all covered employees (including the clergyperson).

However, there is a special transition rule that applies only for 2010. This rule provides that employers who pay at least 50% of the premium for each employee enrolled in coverage are eligible to receive the Tax Credit, even if they do not pay a uniform percentage of the premium for each covered employee. For example, a church that pays 75% of the premium for the minister and 50% of the premium for all other employees enrolled in the health plan would satisfy the uniformity requirement in 2010—but would not satisfy the uniformity requirement in 2011 through 2013.

Health reimbursement arrangements (HRAs), flexible spending accounts (FSAs) and health savings accounts (HSAs) are not Qualifying Arrangements and are not eligible for the Tax Credit.

**Computing Total Premiums Paid**

All premiums paid during the tax year for Qualifying Arrangements, including premiums paid for covering clergy, are counted toward the Tax Credit. Dental and vision benefits are included in the premiums eligible for the Tax Credit. However, the premiums eligible for the Tax Credit are limited by the average premium for policies in the small group market in the state where the employer is located. The state average premiums are listed in the Instructions to Form 8941. If HealthFlex premiums (or other church plan premiums) paid by the church employer exceed the state average premiums, the Tax Credit will be limited to what the church would have paid for a policy with the state average premium.

**Eligible Tax Years**

The Tax Credit is available for up to six years and begins in the 2010 tax year. The Tax Credit applies to health insurance or church plan health benefits from the 2010 tax year through the 2013 tax year. For 2014 and 2015, the Tax Credit increases to a maximum of 35% of premiums, but only applies to premiums paid by the employer for coverage purchased from the state health care exchanges, which will be established by each state under the PPACA.
How to Take the Tax Credit

The Tax Credit for tax-exempt employers, like churches, is taken as a credit against any federal income taxes and Medicare taxes withheld from employees’ pay, plus the Medicare tax liability that the employer may have to the IRS. If a church has only clergy employees and is not paying any FICA taxes or withholding any federal income taxes, the Tax Credit will not be of any value. However, if the clergyperson elects to have federal income tax voluntarily withheld and remitted by the church employer, the employer may have sufficient withheld taxes upon which to apply the Tax Credit.

For church employers and other tax-exempt entities, the Tax Credit is claimed as a refundable credit by submitting two tax forms:

- The church employer must complete a Form 8941, which is used to calculate FTEs, average wages, health insurance premiums and the amount of the Tax Credit.
- The church employer must also complete a Form 990-T, which is usually used to report taxes on unrelated business income. Churches do not generally file this form.
  - In the past, some churches may have completed a Form 990-T to claim a refund of federal excise taxes on telephone bills.
- The church employer should enter the results from Form 8941 on line 44f on the Form 990-T, and attach Form 8941 to the Form 990-T.
- The filing deadline for the Form 990-T for employers with a fiscal year ending December 31, 2010 is May 15, 2011.

Example 1—Basic Calculation

A church has five employees: one clergyperson and four lay employees (two who work full time and two who work part time). The clergyperson and the full-time employees each work 2,000 hours/year, while the two part-time employees each work 1,500 hours/year. The staff is paid as follows: $60,000 for the clergyperson; $35,000 for Employee 1; $25,000 for Employee 2; and $12,500 for each part-time employee. All wages, including those paid to the clergyperson, are Form W-2 wages. The church has enrolled its clergyperson and the two full-time employees in its annual conference health plan. The cost of single employee-only health care coverage is $5,000 (which is less than the state average premium, for example, $5,198 in Illinois) and the church pays 75% of this premium on behalf of each covered employee ($3,750 for each employee).

- **Step One:** Calculate the FTEs for the church by adding up the hours each employee (including the clergyperson) worked during the year and dividing by 2,080; then round that amount down to the next whole number:

  
  \[
  \begin{align*}
  2,000 \text{ (clergy)} + 2,000 \text{ (EE 1)} + 2,000 \text{ (EE 2)} + 1,500 \text{ (EE 3)} + 1,500 \text{ (EE 4)} &= 9,000 \text{ total hours} \\
  9,000 \div 2,080 &= 4.3 \\
  \text{Total number of FTEs} &= 4 \text{ (4.3 rounded down to next whole number)}
  \end{align*}
  \]

- **Step Two:** Calculate the average wages by adding the wages of all FICA employees and dividing by the number of FTEs (as determined under Step One). Then round down to the nearest $1,000. **Note:** Although the clergyperson’s hours are counted for purposes of determining FTEs in Step One, the clergyperson’s wages are not counted for purposes of determining average wages in Step Two because the clergyperson has no FICA wages.

  \[
  \begin{align*}
  $35,000 \text{ (EE 1)} + $25,000 \text{ (EE 2)} + $12,500 \text{ (EE 3)} + $12,500 \text{ (EE 4)} &= $85,000 \text{ total wages} \\
  $85,000 \text{ (total wages)} \div 4 \text{ (number of FTEs)} &= $21,250 \\
  \text{Average wages} &= $21,000
  \end{align*}
  \]
• **Step Three:** Calculate amount of Tax Credit. Because this church has fewer than 10 FTEs and average wages are under $25,000, the church is eligible for the full Tax Credit of 25%.

  Employer Cost = $3,750 x 3 (covered employees) = $11,250  
  Tax Credit = 25% x $11,250 (Employer Cost) = $2,812.50

  **Note:** The amount of the Tax Credit cannot exceed the total amount of income and Medicare tax the church is required to withhold from employees’ wages for the year and the church’s share of Medicare tax on employees’ wages for the year.

**Example 2—Annual Conference Plan Premium Exceeds State Average for Small Group Market**

Example 2 uses the same facts as Example 1, except that the church is located in Alabama. According to the Instructions to Form 8941, the state average premiums for small group markets in Alabama is $4,441, which is less than $5,000 (the cost of single employee-only coverage under the annual conference health care plan). For purposes of calculating the Tax Credit, the cost of employee-only health care coverage is limited to $4,441, not $5,000.

• **Step One** and **Step Two** are the same as Example 1.

• **Step Three:** Calculate amount of the Tax Credit. The Tax Credit is limited to the amount the church would have paid if each employee taken into account were covered by a policy with a premium equal to the average premium for the small group market in Alabama. Because the state average premium is less than the actual cost under the denominational health plan, the church must use the state average premiums (i.e., $4,441 in this example) for purposes of determining the amount of Tax Credit. Further, because the church is contributing 75% of the cost of coverage under the annual conference plan, the amount the church would have paid if the premium were equal to the state’s average premium is 75% of $4,441 ($3,330.75).

  Employer Cost (if cost was equal to state average premium) = 75% x $4,441 = $3,330.75  
  $3,330.75 x 3 (covered employees) = $9,992.25  
  Tax Credit = 25% x $9,992.25 (Employer Cost) = $2,498.06

  **Note:** Again, the amount of the Tax Credit cannot exceed the total amount of income and Medicare tax the church is required to withhold from employees’ wages for the year and the church’s share of Medicare tax on employees’ wages for the year.

**Example 3—Annual Conference Plan Premium Exceeds State Average for Small Group Market**

Under **Step One**, the church determined that is has 12 FTEs. Under **Step Two**, the church determined that it pays average wages of $27,000. The church has enrolled 10 employees in its denominational church health plan. The cost of single employee-only health care coverage is $5,000 (which is less than the church’s state average premium) and the church pays 85% of this premium on behalf of each covered employee (i.e., $4,250 for each employee). The total amount of income tax and Medicare tax the church is required to withhold from employees’ wages and the church’s share of Medicare tax on employees’ wages for the year was $6,250.

• **Step Three:** Calculate amount of Tax Credit.

  Because this church has more than 10 FTEs and average wages are over $25,000, the church is not eligible for the full Tax Credit of 25%. The Tax Credit percentage must be reduced in accordance with Appendix A.

  Employer Cost = $4,250 x 10 (covered employees) = $42,500  
  Tax Credit Percentage under Appendix A = 17%  
  Tax Credit = 17% x $42,500 = $7,225  
  Total Income Tax Withholding and Medicare Taxes = $6,250  
  Tax Credit = $6,250
Note: The total amount of the federal income tax withholding and Medicare tax withheld from employees’ wages for the year plus the employer’s share of Medicare tax on employees’ wages for the year is less than the maximum amount of the Tax Credit available. Therefore, the church cannot claim the full amount of the Tax Credit available, unless its clergy voluntarily elect to have the church withhold federal income taxes from their compensation in order to take full advantage of the Tax Credit.

Additional Information
For additional information about the Tax Credit, visit the IRS’s website at http://www.irs.gov/newsroom/article/0,,id=231928,00.html. A detailed discussion of how to calculate the Tax Credit is included in the instructions to Form 8941, which can be found at http://www.irs.gov/pub/irs-pdf/i8941.pdf. More information about the Tax Credit and how health care reform may impact the health plans of The United Methodist Church is available in the Health Care Reform section of the General Board website. Please submit any questions to healthcarereform@gbophb.org. You also can learn more about health care reform in general at www.healthcare.gov.

Appendix—Small Business Tax Credit Proration, Nonprofit Firms in 2010-2013

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<th>Firm or Church Size</th>
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